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IN THE

Supreme Court of The United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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vs.

HENRY T. SANDERS,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on October 30, 1975.

OPINIONS BELOW

The Court of Appeals has rendered two opinions in separate appeals in this action. The more recent opinion is reported at 524 F.2d 1064 (1975) and is printed in the appendix to this petition (A. 1-19). The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, from which that appeal was taken, not officially reported, is printed in the appendix to this petition (A. 20-48). The prior opinion of the Court of

Appeals in this action is reported at 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972), and is printed in the appendix to this petition (A. 49-64).* The two orders of the District Court from which the first appeal in this action was taken are also printed in the appendix (A. 65-68).

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit sought to be reviewed was entered on October 30, 1975. This petition for certiorari was filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Is a promissory note with a maturity of ninety days a security subject to the provisions of the Securities Exchange Act of 1934, notwithstanding that the definition of "security" in Section 3(a)(10) of that Act expressly excludes "any note . . . which has a maturity at the time of issuance of not exceeding nine months"?

2. Absent a finding of deliberate or intentional fraud or of reckless or willful conduct or of knowledge of another's fraud, may a dealer in short-term promissory notes be subjected to liability for damages under Rule 10b-5 under the Securities Exchange Act of 1934, an issue similar to that now under advisement in this Court in *Ernst & Ernst v. Hochfelder*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042)?

3. In light of this Court's opinion in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), may a dealer in short-term promissory notes who purchases and resells

* Unless otherwise noted, all references to the Court of Appeals' action are to its more recent opinion.

such notes in reliance on an unqualified audit report of the issuer's independent accountants be liable for damages under Rule 10b-5 for failing to examine the accountants' working papers, notwithstanding that under the express liability provisions of Section 11 of the Securities Act of 1933 an underwriter is specifically excluded from liability if he relied upon the report of an expert, such as an independent public accountant?

4. Did the Court of Appeals correctly determine the duty of investigation of a dealer in short-term promissory notes under the federal securities laws in light of the unique nature of the market for such notes?

STATUTES AND RULE INVOLVED

Sections 2(11), 3(a)(3), 11 and 12 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§ 77b(11), 77c(a)(3), 77k and 77*l*, Sections 3(a)(10) and 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §§ 78c(a)(10) and 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, are set forth in the appendix hereto (A. 69-77).

STATEMENT OF THE CASE

A. The Transactions and Parties Involved

1. The Defendants-Petitioners

At all times material hereto John Nuveen & Co., Inc. ("Nuveen") was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). In September of 1968, Nuveen acquired the business of Ashwell & Co. ("Ashwell"), a Chicago-based dealer in short-term promissory notes (hereinafter referred to as "commercial paper").* On September 15, 1969, Investors Syndicate of America, Inc.

* Commercial paper consists of unsecured, short-term promissory notes, payable to the bearer at a stated maturity, never more than 270 days. The notes are either interest-bearing notes or discount notes without interest.

("ISA"), a wholly-owned subsidiary of Investors Diversified Services, Inc. ("IDS"), acquired all of the stock of Nuveen.

2. Winter & Hirsch, Inc.

Winter & Hirsch, Inc. was one of the companies whose commercial paper was sold by Ashwell (since the 1930's) and later by Nuveen. Winter & Hirsch was a consumer finance company which had been in business in Chicago since 1915 and was held in very high regard by financial institutions. Winter & Hirsch obtained funds to lend from various sources, including unsecured bank loans, long-term loans, and the sale of commercial paper. As Nuveen knew, more than seventy banks, including forty Chicago-area banks, lent money to Winter & Hirsch during the period at issue in this case.*

3. Lieber, Bleiweis and Company

At all times material hereto, and beginning some time prior to 1960, the certified public accounting firm of Lieber, Bleiweis and Company ("Lieber, Bleiweis") and predecessors thereto issued semi-annual audited statements of Winter & Hirsch. Lieber, Bleiweis was duly licensed to practice public accounting in the State of Illinois.

Nuveen, as well as the major bank and insurance company lenders to Winter & Hirsch, all relied upon the audit reports issued by Lieber, Bleiweis. The Court of Appeals assumed for purposes of its decision (in accordance with petitioners' contention) that the reports were not defective or qualified and that "nothing in the audits themselves gave Nuveen any special reason to question their accuracy." (A. 7).

* Eleven of the fifty largest banks on the Fortune Directory were lenders to Winter & Hirsch in this period. *Fortune*, July, 1974, p. 114.

4. The Plaintiff-Respondent

Plaintiff-respondent Sanders (hereinafter "Sanders") purchased from Nuveen a $35,000 principal amount ninety-day promissory note of Winter & Hirsch.* He represents a class consisting of 43 purchasers from Nuveen of Winter & Hirsch commercial paper, all purchased prior to February 10, 1970, with an aggregate face amount of $1,600,000.**

B. Nuveen's Investigation of Winter & Hirsch

Prior to the first sale of Winter & Hirsch commercial paper at issue here, Nuveen made an extensive investigation of Winter & Hirsch. In December 1968, Nuveen's commercial paper credit analyst reviewed the most recent audited financial statements of Winter & Hirsch (as of August 31, 1968), which Lieber, Bleiweis had certified. In March 1969, the analyst spent an entire day at the main office of Winter & Hirsch meeting with its officers and making a check of its records, with particular attention to the collection procedure for delinquent accounts and to a determination of whether proper documentation supported its accounts receivable. Nothing in that on-site examination disclosed any adverse information about Winter & Hirsch.

In addition, written inquiries of banks that were lenders to Winter & Hirsch elicited generally laudatory responses.

* The note purchased by Sanders was a discount note reading as follows:

WINTER & HIRSCH, INCORPORATED
$35,000.00 January 30, 1970 No. 7351

On April 30, 1970 for value received we promise to pay to the order of bearer the sum of Thirty Five Thousand and 00/100 Dollars payable at the principal office of First National Bank of Chicago

Not Negotiable Unless Countersigned

WINTER & HIRSCH, INCORPORATED

By /s/ Sheldon Tucker
Counter Signature

By /s/ Milton Hirsch
Authorized Officer

** As a result of payments on behalf of Winter & Hirsch, net claims against the petitioners aggregate approximately $575,000, exclusive of interest.

In late 1969 a later financial statement of Winter & Hirsch, certified by Lieber, Bleiweis, was reviewed by Nuveen and in early 1970 further inquiries were made by it of bank lenders.

C. Discovery of The Winter & Hirsch Fraud

In the fall of 1969 rumors about Winter & Hirsch began to reach a few of its bank lenders, but not Nuveen. As a result of pressure from two of these lenders, on January 9, 1970 Winter & Hirsch retained another public accounting firm, Peat, Marwick, Mitchell & Co. ("Peat, Marwick"), to conduct an audit as of January 31, 1970. The circulation of the rumors and the commencement of the audit were unknown to Nuveen until February 10, 1970. Despite importunings from one of Winter & Hirsch's bank lenders, Nuveen immediately ceased selling Winter & Hirsch commercial paper. The opinions of neither the District Court nor the Court of Appeals suggested any dereliction on the part of Nuveen for not having sooner learned of these facts.

Approximately five weeks after its audit had begun, Peat, Marwick discovered a discrepancy of approximately $14,000,000 between Winter & Hirsch's actual accounts receivable and the total shown on its books and in the most recent Lieber, Bleiweis audit report. It was subsequently learned that the discrepancy resulted from a fraudulent inflation of the firm's books by the management of Winter & Hirsch, which had occurred piecemeal over a period of ten years or more. It was also determined that, despite its certificate to the contrary, Lieber, Bleiweis had not audited Winter & Hirsch but instead had relied largely on information supplied by management. The principals of both Winter & Hirsch and Lieber, Bleiweis subsequently pleaded guilty to federal criminal fraud charges.

Following discovery of the fraud all payment of Winter & Hirsch debt, including the commercial paper owned by Sanders and members of the class represented by him, was suspended.

D. Proceedings Below

On March 12, 1970, Sanders filed a class action complaint against thirteen defendants, including Nuveen, IDS, and ISA.* Sanders contended that petitioners and the other defendants violated certain provisions of the federal securities laws** in connection with the sale by Nuveen of the commercial paper issued by Winter & Hirsch during an eight-month period beginning in June, 1969.

Petitioners filed a motion in the District Court challenging, *inter alia*, that court's jurisdiction under the 1934 Act on the ground that the short-term promissory note purchased by respondent was not a "security" subject to the provisions of the 1934 Act, and its sale, therefore, could not violate the 1934 Act or any rule or regulation thereunder. The District Court denied petitioners' motion without opinion and subsequently certified to the Court of Appeals for the Seventh Circuit, pursuant to 28 U.S.C. § 1292(b), the question whether commercial paper in the form of a conventional promissory note with a maturity of

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* Nine defendants other than those named above were dismissed by stipulation with the approval of the District Court. The Court of Appeals reversed the District Court's judgment imposing liability on a tenth defendant, Alleghany Corporation.

** The complaint as amended to the time of trial asserted claims under Sections 12(2) and 17 of the 1933 Act, 15 U.S.C. §§ 77*l*(2) and 77q, respectively; Sections 10(b) and 20 of the 1934 Act, 15 U.S.C. §§ 78j(b) and 78t, respectively; Rule 10b-5 promulgated by the SEC under the 1934 Act, 17 C.F.R. § 240.10b-5, and certain of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. The holding of the Court of Appeals was based solely on Rule 10b-5 under the 1934 Act (A. 6-7), except that the liability of IDS and ISA was predicated on their alleged status as controlling persons of Nuveen under Section 20 of the 1934 Act, 15 U.S.C. § 78t. In this petition no question is raised under Section 20.

nine months or less is a "security" as defined in Section 3(a)(10) of the 1934 Act (A. 66).

The Court of Appeals granted permission to appeal and in its first opinion (*"Sanders I"*) held that the note purchased by Sanders was a "security" within the meaning of Section 3(a)(10). The court held that, although under the terms of the 1934 Act "a note with a maturity not exceeding nine months [is] withdrawn from the application of the anti-fraud provisions of the act" (A. 54), the note purchased by Sanders with a maturity of only ninety days nevertheless was a "security" subject to the antifraud provisions of the 1934 Act (A. 56-58). Accordingly, the court ordered a trial on the merits.*

Following trial the District Court found in favor of Sanders and against the petitioners (A. 20-48). After further proceedings concerning claims of individual class members and petitioners' objections thereto, the District Court sustained all claims filed and petitioners appealed.

In its second opinion in this case (*"Sanders II"*), the Court of Appeals affirmed the judgment against Nuveen, ISA and IDS and affirmed the rulings denying petitioners' objections to claims of individual class members. Specifically, the Court of Appeals adopted the reasoning and holding of its opinion in *Sanders I* as to the term "security" (A. 6, n.8) and further held that Nuveen had violated its obligations as an "underwriter" of a security, that "Nuveen's investigation of [Winter & Hirsch] was deficient, and that an appropriate investigation would have revealed the fraud." (A. 9).

* Petitioners thereafter sought certiorari to this Court. The petition was denied. 409 U.S. 1009 (1972).

REASONS FOR GRANTING THE WRIT

I. The Decision Below That Notes With A Maturity Of Less Than Nine Months Were Securities Within The Meaning Of Rule 10b-5 Under The Securities Exchange Act Of 1934 Directly Contravenes The Definition Of "Security" In That Act*

The Court of Appeals held that although all the notes in question had a maturity of less than nine months, they were nevertheless securities as defined in Section 3(a)(10) of the 1934 Act. The Court of Appeals committed error in so holding because Section 3(a)(10) of the 1934 Act explicitly states:

> "The term 'security' means any note, . . . but *shall not include* currency or *any note*, draft, bill of exchange, or banker's acceptance *which has a maturity at the time of issuance of not exceeding nine months*, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (emphasis added)

As stated by this Court in another case under the 1934 Act:

> "[W]hatever the rationale of the proviso [in the statute], it cannot be disregarded simply on the ground that it may be inconsistent with . . . the 'wholesome purpose' of the Act.
>
> • • •
>
> "[W]e are not free to adopt a construction that not only strains, but flatly contradicts, the words of the statute." *Reliance Electric Co. v. Emerson Electric Co.* 404 U.S. 418, 424, 427 (1972).

The holding on this issue in *Sanders I* came as a surprise to the commercial paper industry, which had always con-

* This issue was the subject of the interlocutory petition for certiorari referred to in note * on page 8 *supra*. The Court of Appeals having reaffirmed its position after development of a complete record, the matter is now ripe for resolution by this Court. *See, e.g., Mercer v. Theriot*, 377 U.S. 152, 153-154 (1964); Stern and Gressman, *Supreme Court Practice* 27 (4th ed. 1969).

sidered commercial paper as excluded from the 1934 Act definition of "security". *Wall Street Journal,* November 14, 1972, p. 2 (Midwest ed.) The SEC had taken a similar position:

> ". . . commercial paper having a maturity up to 270 days is not a security for purposes of the Exchange Act of 1934." Staff Report of the S.E.C. to the Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, *The Financial Collapse of the Penn Central Company* (Aug. 1972) at viii; *see also id.* 273-274. (hereinafter cited as *"Penn Central Report"*).*

At the time of the petition for a writ of certiorari to review the decision of the Court of Appeals in *Sanders I,* there had been only a handful of decisions construing Section 3(a)(10), including three which held that short-term notes were not securities.** Since denial of that petition, however, a number of cases have followed the holding or rationale of *Sanders I* (holding either that short-term notes were securities, *e.g., Zeller v. Bogue Electric Manufacturing Corp.,* 476 F.2d 795 (2nd Cir. 1973), *cert. denied,* 414 U.S. 908 (1973), or that longer-term notes were not securities, *McClure v. First National Bank,* 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975)). Some of these decisions have reached such results with explicit recognition of the violence done to the statutory language:

* The report noted that the opinion in *Sanders I* reached a contrary result, having applied to Section 3(a)(10) of the 1934 Act a standard appearing only in the 1933 Act. *Id.* 274, n. 4. *See* Part IV-2 *infra.*

** *Investment Properties Int'l, Ltd. v. I.O.S.,* CCH Fed.Sec.L.Rep ¶ 93,011 at 90,726 (S.D.N.Y. 1971) [1970-71 Transfer Binder]; *Securities and Exchange Commission v. Fifth Avenue Coach Lines, Inc.,* 289 F.Supp. 3, 38 (S.D.N.Y. 1968), *aff'd,* 435 F.2d 510 (2d Cir. 1970); *Superintendent of Insurance v. Bankers Life and Casualty Co.,* 300 F. Supp. 1083, 1100 (S.D.N.Y. 1969), *aff'd,* 430 F.2d 355 (2d Cir. 1970), *rev'd on other grounds,* 404 U.S. 6 (1971).

> "We realize that our holding today [interpreting Section 3(a)(10) of the 1934 Act] that the Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. . . . The original scrivener of the definitional section may well wonder what happened to his carefully drawn exemption on the way to the courthouse, but if the judicial decisions do not properly reflect the intent of Congress as to the coverage of the Act, only that body can properly rectify the situation at this point, if stare decisis is to apply and the Supreme Court does not make some definitive decision contrary to the presently decided cases." *McClure v. First National Bank,* 497 F.2d 490, 494-495 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975).

The foregoing language was quoted by the Court of Appeals for the Seventh Circuit in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.,* 508 F.2d 1354, 1360 n. 13 (7th Cir. 1975), *cert. denied,* 96 S.Ct. 38 (1975).* The instant case affords an appropriate opportunity for this Court to "rectify the situation" by making a "definitive decision contrary to the presently decided cases."

As of the end of September, 1975, the amount of commercial paper outstanding in the United States exceeded 48.2 billion dollars in principal amount, of which 17.8 billion was dealer-placed.** The enormous dollar amounts involved in sales of commercial paper underscore the need for a definitive decision by this Court as to whether commercial paper is a security subject to the 1934 Act. Resolution of this basic definitional question takes on added importance in light of the expanded duties of investigation

* Although certiorari was denied in *McClure* and in *C.N.S. Enterprises, Inc.,* both cases held that notes with a maturity of longer than nine months were *not* securities, rather than the reverse.

** FEDERAL RESERVE BULLETIN, December, 1975, vol. 61 at A-25. As reported therein, 12.2 billion issued by non-financial companies is not separated between dealer-placed and directly-placed; however, petitioners understand that paper issued by non-financial companies is dealer-placed, not directly-placed.

and exposure to civil liability under the 1934 Act which the decision below will impose upon commercial paper dealers.*

II. The Decision Below Presents Important Additional Perspectives As To The *Scienter* Issue Under Rule 10b-5 That Is Before This Court In *Ernst & Ernst v. Hochfelder*

In *Sanders II* the Court of Appeals described the principal question at issue therein as

> "whether an underwriter of short term commercial paper, who acted in the *mistaken but honest belief*** that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default." (A. 1) (emphasis and footnote added).

In posing this question the court below assumed that the audit reports were appropriately certified and that nothing in the audit gave Nuveen any special reason to question their accuracy (A. 7). Nevertheless, the court answered the basic question in the affirmative and held that Nuveen, which it denominated an "underwriter"***, "breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud" (A. 1). It thus imposed liability under Rule 10b-5 without requiring any showing of *scienter, i.e.,* intent to defraud, actual knowledge of misrepresentations or omissions, or a willful, deliberate or reckless disregard for the truth that is the equivalent of knowledge. *Lanza v. Drexel & Co.,* 479 F.2d 1277, 1305 (2d Cir. 1973).

* The separate question of exemption of commercial paper from the registration provisions of the 1933 Act will be treated below as part of the discussion of the duty of investigation that should be required of a commercial paper dealer. (Part IV-2 *infra*).

** Nuveen's "honest belief" as to the condition of the issuer was not the result of a blind acceptance of statements by Winter & Hirsch and its auditors. Its belief was based on its extensive and continuing investigation of Winter & Hirsch which included but went well beyond the audit reports. *See* pp. 5-6 *supra*.

*** As discussed in Part III *infra*, the court erroneously characterized Nuveen as an underwriter for purposes of invoking an underwriter's duty of investigation akin to—or beyond—that of Section 11 of the 1933 Act.

1. This Court Has Granted a Petition for a Writ of Certiorari and Has Heard Oral Argument in *Ernst & Ernst v. Hochfelder,* Raising Similar Issues With Regard to Accountants

In *Sanders II* the court below specifically stated that "Nuveen's liability in this case must rest on Rule 10b-5" (A. 6); yet it upheld Nuveen's liability as a dealer in commercial paper on the basis of proof of, at most, negligence. A similar holding with respect to independent auditors is currently before this Court in *Ernst & Ernst v. Hochfelder,* 503 F.2d 1100 (7th Cir. 1974), *cert. granted,* 421 U.S. 909 (1975) (No. 74-1042).* The instant case presents a *scienter* issue similar to that of *Ernst & Ernst* in the context of the market for commercial paper, an extremely important and vital aspect of American capital markets, and it also necessarily raises that issue in relation to the duties of dealers generally. Moreover, this case, like *Ernst & Ernst,* involves an alleged breach of a duty to make inquiry, rather than an affirmative misrepresentation.

While this case involves issues not involved in *Ernst & Ernst,* if this Court holds in *Ernst and Ernst* that negligence may not support liability under Rule 10b-5, petitioners urge this Court to grant this petition and reverse summarily.

2. A Conflict Between Circuits Exists on the Question Whether Civil Liability Under Rule 10b-5 Can Be Based on Negligence

As apparently recognized by this Court when it granted the petition for certiorari in *Ernst & Ernst v. Hochfelder,* there is a conflict of authority among federal courts of

* The Court granted a petition for a writ of certiorari in *Ernst & Ernst* on the following question: "1. Whether Respondents may predicate a cause of action against Petitioner for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, on an allegation of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?" Petition for Writ of Certiorari, 421 U.S. 909 (1975).

appeals on the question whether civil liability under Rule 10b-5 may be based on negligence. The Second, Fifth and Tenth Circuits have held that negligence will not support an action under Rule 10b-5;* the Seventh, Eighth and Ninth Circuits have disagreed;** and the other Circuits have not yet definitively addressed the question.*** The instant case is another decision of the Seventh Circuit applying a negligence standard.

3. The Language of Section 10(b) and of Rule 10b-5 Does Not Permit Liability Based on Negligence

Section 10(b), which prohibits "any manipulative or deceptive device or contrivance", on its face requires conduct connoting fraud. If and to the extent that Rule 10b-5 is construed to support liability in damages for conduct which amounts only to negligence, the rule would be beyond the scope of the statute and therefore invalid. 6 Loss, *Securities Regulation* 3884 (Supp. to 2d ed., 1969); *cf. Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

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* Second Circuit: In *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), a case involving a brokerage firm, the Second Circuit has stated that the plaintiff's claim was not actionable under Rule 10b-5 "in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." 448 F.2d 442, 445. *See also Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) ("proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."); Fifth Circuit: *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974) ("some culpability beyond mere negligence"); Tenth Circuit: *Clegg v. Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) ("there is required something additional by way of scienter or conscious fault than mere negligence. . . .").

** The two circuits other than the Seventh Circuit have held, in cases involving misrepresentations, that negligence is an appropriate standard: Eighth Circuit: *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); Ninth Circuit: *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (adopting a flexible duty standard); *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1278 (9th Cir. 1975); *Clark v. Watchie*, 513 F.2d 994, 999 (9th Cir. 1975), *cert. denied*, 96 S.Ct. 72 (1975).

*** The Sixth Circuit has addressed the question in a narrow injunction setting: *Securities and Exchange Commission v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) (conscious intent required in an aiding and abetting injunction case).

Further, the language of Rule 10b-5 as applied to this case requires a showing greater than negligence. The court below did not base its conclusion upon any transmission of information by Nuveen to members of the class, but rather stated that "the relationship between the underwriter and its customers *implicitly* involves a favorable recommendation of the issued security" (A. 8) (emphasis added). Since the court imposed liability on a theory not involving any affirmative misrepresentation, clause (2) of Rule 10b-5 is inapplicable. Liability must therefore rest on one of the two other clauses, both of which use classic fraud language, to wit: "(1) to employ any device, scheme, or artifice to defraud, . . . (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, . . ." The words "defraud" and "fraud or deceit" surely require a degree of culpability greater than negligence, as the Courts of Appeals of the Second, Fifth and Tenth circuits have held. *See* cases cited in note * page 14 *supra*.

The following statement of this Court, in a very recent case construing an express liability provision of the 1934 Act, is *a fortiori* pertinent in a case involving a claim of implied liability under Section 10(b) of the 1934 Act and Rule 10b-5:

> "It is inappropriate to reach the harsh result of imposing § 16(b)'s liability without fault on the basis of unclear language. If Congress wishes to impose such liability, we must assume it will do so expressly or by unmistakable inference." *Foremost-McKesson, Inc. v. Provident Securities Co.*, 44 U.S.L.W. 4056, 4062 (January 13, 1976).

III. In Creating An Implied Liability Under Rule 10b-5 That Exceeds The Bounds Of Comparable Express Liability Provisions, The Decision Below Is Contrary To The Doctrine Of *Blue Chip Stamps v. Manor Drug Stores*

In *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975), this Court held that a plaintiff who had neither purchased nor sold securities did not have standing to bring an action under Rule 10b-5. In so holding, the Court turned for guidance to the "principal express nonderivative private civil remedies" of the federal securities laws, *viz.,* Sections 11 and 12 of the 1933 Act and Sections 9 and 18 of the 1934 Act. 421 U.S. at 735-736. After examining those sections this Court stated, "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." 421 U.S. at 736. This Court thus indicated that in situations analogous to those for which private express remedies were created under the federal securities laws Rule 10b-5 must be construed as containing the limitations which are set forth in those express statutory provisions. The court below erred in failing to follow that principle.

1. In Concluding That a Commercial Paper Dealer May Not Rely on an Unqualified Audit Report But Must Examine the Independent Accountants' Underlying Work Papers, the Decision Below Imposed a Greater Burden on Such a Dealer For Purposes of Implied Liability Under Rule 10b-5 Than Is Imposed on an Underwriter Under Section 11 of the Securities Act of 1933

In *Sanders II,* the Court of Appeals held that under Rule 10b-5 Nuveen was not entitled to rely on an unqualified

certified audit report by a firm of independent accountants to conclude that Winter & Hirsch was in good financial condition. Rather, the court stated that Nuveen should have examined the independent accountants' underlying work papers (A. 7). This burden is far greater than that which Congress placed on an underwriter of a public offering of securities registered under the 1933 Act, which was specifically tailored by Congress to protect the investing public in connection with distributions of securities and to allocate liabilities in connection therewith.

Liability of an underwriter in a registered public offering is determined under Section 11 of the 1933 Act, a detailed civil liability provision which contains a number of defenses available to underwriters and others. Those defenses include one that

> "no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . that . . . as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, ..." Section 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C).

In other words, an underwriter in a registered offering has no affirmative duty to verify the accuracy of the report of an expert, such as an independent public accountant, unless he has reasonable ground to believe the report to be inaccurate. *Escott v. BarChris Construction Corp.,* 283 F.Supp. 643, 697 (S.D.N.Y. 1968).

By imposing a duty of verification of an accountants' report upon Nuveen, despite its "honest belief" (A. 1) that

the certified financial statements correctly represented the financial condition of the issuer, the decision below is manifestly inconsistent with the doctrine of *Blue Chip Stamps*. Moreover, petitioners are unaware of *any* case requiring a seller of securities to verify an accountants' report which it reasonably believed to be correct.

2. The Decision Below Otherwise Improperly Disregarded the Statutory Pattern of Express Civil Liabilities of the Federal Securities Laws

The holding in *Sanders II* that Nuveen had an underwriter's duty of investigation is also inconsistent with *Blue Chip Stamps*.

In Sections 11, 12(1) and 12(2) of the 1933 Act, Congress carefully established a system of remedies for buyers of securities. Section 11 is available to buyers of securities issued pursuant to a false registration statement, Section 12(1) is available when securities are sold in violation of the registration requirements of Section 5, and Section 12(2) is available when securities, whether or not required to be registered, are sold by means of a false written or oral communication.

The Court of Appeals expressly recognized that Section 11 was not applicable in the instant case because there was no registration statement (A. 6). It also expressly recognized that Section 12(2) was not applicable because there was no finding of violation as to any written or oral communication and there was no evidence of reliance on express recommendations by Nuveen (A. 6-7). Yet the court, looking solely to Rule 10b-5 as the basis for implied liability, imposed upon Nuveen as an "underwriter" of commercial paper* a duty of investigation at a substantially higher

* The court's statement that "The conclusion that Nuveen was an underwriter for Winter & Hirsch is not challenged" (A. 3) misconstrues petitioners' position. If, contrary to petitioners' position, commercial

threshold than the duty of reasonable care imposed under Section 12(2) of the 1933 Act on sellers of securities generally.*

Notwithstanding that it found Section 11 of the 1933 Act inapplicable, the court below relied primarily on Section 11 cases regarding special obligations of underwriters of registered offerings,** and thus ignored the statutory distinction between offerings registered under the 1933 Act and other sales. In particular, the court stated that, "[w]hether reviewing the underwriter's duty to investigate under the standards of § 11 applicable to registration statements or under the standards of Rule 10b-5," the following passage from *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968) is pertinent:

> "To effectuate the statute's purpose the phrase 'reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company." (A. 8-9, n. 18.)

* (Continued)
paper is a security for purposes of Rule 10b-5 under the 1934 Act, a commercial paper dealer might literally come within the definition of "underwriter" found in the 1933 Act, which includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, . . ." Section 2(11), 15 U.S.C. § 77b(11). But this still does not mean (as petitioners have consistently argued) that the Section 11 standards, which are applied to underwriters of offerings covered by 1933 Act registration statements, are applicable under Rule 10b-5 to sales not involving a registration statement. This is the critical question.

* And, with respect to reliance on an unqualified audit report, a duty even higher than that imposed on 1933 Act underwriters. *See* Part III-1 *supra*.

** Thus, the court cited with approval two cases involving registration statements decided under Section 11, *Feit v. Leasco Data Processing Corp.*, 332 F.Supp. 544, 581 (E.D.N.Y. 1971) (A. 8, n. 16) and *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968) (A. 8-9, n. 18). It also referred to *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973), a case discussing the duties which an underwriter owes "to pass on the soundness of the security and the correctness of the registration statement and prospectus" (A. 8, n. 17).

But the words "reasonable investigation" emphasized in this passage (as well as the word "underwriter") appear only in Section 11, not in Section 12(2) of the 1933 Act or in Rule 10b-5. In Section 12(2), the provision dealing with liabilities of sellers generally, there is no singling out of a category of underwriters. Liability is predicated on use of communications which the seller knew or "in the exercise of reasonable care could . . . have known" were untrue or misleading. Congress obviously used different language in dealing with different situations, and other courts have emphasized the importance of the difference: an affirmative, active duty of investigation in the case of a registered offering, a more passive duty of vigilance in the case of sellers generally. *See Levine v. Securities and Exchange Commission*, 436 F.2d 88 (2d Cir. 1971);* *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (drawing a sharp distinction between Section 11 and non-Section 11 sales of securities with respect to directors' duty to investigate).** *See also* the following statement by the SEC in August 1972, contrasting disclosure and investigation practices for offerings registered under the 1933 Act and typical commercial paper sales:

> "In the absence of registration requirements, there are no customary standards requiring disclosure of material information, to the extent the same is disclosed in a statutory prospectus, to purchasers. . . . Furthermore, there is no investigation undertaken by the dealer which would even approximate that which is required of an underwriter of a security offering registered . . .

* "Of course, absent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to re-examine the books of every company, the stock of which he may offer for sale, even accepting the doubtful hypothesis that such permission would be granted." 436 F.2d at 90.

** "Congress chose to impose upon directors through Section 11 of the 1933 Act a duty to insure that all material, adverse information is conveyed to prospective purchasers of the Company's stock. The history of the section demonstrates that the matter was carefully considered and the duties were precisely defined. *To argue that a section of the 1934 Act,*

pursuant to the 1933 Act." *Penn Central Report* at 273-274.*

Under the *Blue Chip Stamps* doctrine this distinction, built into the express liability provisions, between the "reasonable investigation" duty of an "underwriter" in a registered offering and the "reasonable care" standard applicable to other types of sellers and sales may not be disregarded, as the Court of Appeals did in *Sanders II* in creating an implied liability under Rule 10b-5.** The end result of ignoring this distinction is to turn Rule 10b-5's prohibition of fraud and deception into an affirmative obligation that is unrealistic and unworkable in relation to the commercial paper market.***

** (Continued)
which neither by its terms nor its history manifests a similar attention to the careful balance struck in Section 11, and which would impose upon directors the same duties as Section 11 and more, is to thwart, not to serve, the purpose of Congress and the dictates of sound policy. . . ." 479 F.2d at 1309 (emphasis added).

* Although recommending legislative changes, the SEC made no suggestion that the differing practices described were illegal under existing law.

** Petitioners recognize that in administrative proceedings involving broker-dealer conduct the SEC has sometimes extended the Section 11 duty of investigation, or something akin thereto, to exempt offerings. *See SEC Release No. 33-5275* (July 26, 1972); *Leonard Lazaroff, SEC Release No. 34-7940* (August 22, 1966); *Charles E. Bailey & Co.*, 35 S.E.C. 33 (1953). But even if the SEC is correct in this position, which petitioners do not concede, the SEC has itself recognized, as have the courts, that standards applied in administrative or injunctive proceedings are not necessarily applicable in damage cases as a matter of implied liability. *E.g.*, Brief for the SEC as Amicus Curiae on Writ of Certiorari to the Court of Appeals for the Seventh Circuit in *Ernst & Ernst v. Hochfelder*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042), pp. 8, 23-33; *Securities and Exchange Commission v. Spectrum, Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973); *Hanly v. Securities and Exchange Commission*, 415 F.2d 589, 596 (2d Cir. 1969).

*** The crowning difficulty with the holding of the court below, of course, is that liability was found in a situation of "honest but mistaken belief"—*i.e.*, in the absence of *scienter*—as discussed in Part II *supra*.

IV. The Decision Below Establishes An Unrealistic And Unworkable Duty Of Investigation, Which Is Likely To Have A Materially Adverse Impact On The Commercial Paper Market

1. The Decision of the Court of Appeals Ignores the Unique Nature of Commercial Paper

Commercial paper is a debt instrument of very short maturity with virtually no secondary market. Thus, factors which might influence other investment decisions involving equity securities or long-term debt (such as long-term profitability, revenue and cost trends, competitive factors, environmental factors and the like) are irrelevant in the case of commercial paper. The important consideration insofar as commercial paper is concerned is the ability of the issuer to pay the notes when they mature. As a result, investigation and analysis will concentrate on the issuer's ability to provide cash by ordinary operations or by borrowing from other sources, such as bank lines of credit, which in turn means focusing on the issuer's current financial statements and its relationship with other lenders, such as banks.*

Therefore, the most crucial concern for a commercial paper purchaser is the integrity of the issuer's current financial statements. These statements are the responsibility of the independent public accountants who certify, *inter alia,* that the receivables shown on the balance sheet exist and appear to be collectible (or that the reserve for bad debts is adequate) and that the liabilities are accurately stated.

* A finance company, such as Winter & Hirsch, is further unique. Its existence is centered on financial transactions in the purest sense. It borrows money; it lends money after checking the credit-worthiness of the borrower and, possibly, the value of the collateral; it collects money owed it; and it pursues delinquent accounts.

The Court of Appeals paid lip service to these factors (A. 9-10) but still imposed an unrealistic and excessive burden of inquiry. Because a gross fraud had been perpetrated by Winter & Hirsch and its outside accountants, the court in effect framed the duty of inquiry in terms of what might have been done to detect the fraud (A. 7-11).

Even an accounting firm rendering an opinion on the financial statements of an issuer does not purport to certify that the issuer has not committed a fraud. *Statement of Auditing Procedure No. 33* ch. 1, para. 5 (AICPA 1963). Inquiries of the kinds that the court below thought Nuveen should have undertaken might theoretically be possible, but would be quite impractical, in the commercial paper market. For example, to examine an accountant's underlying work papers (assuming they would be made available) would require hiring another accountant to audit the work of the issuer's auditor. Likewise, a dealer might need to employ an accountant or legal counsel to examine and understand the significance of an issuer's tax returns or minute books. But the cost of hiring such persons would be prohibitive in light of the relatively low mark-ups normally involved in the marketing of short-term commercial paper as compared with underwriting spreads normally involved in long-term debt or equity financing. Thus, if the duty of inquiry as defined in the instant case were to be applied generally, the commercial paper market would soon be closed to those companies that must rely on dealers to place their paper.

Even under Section 11 an underwriter has a defense of "reasonable investigation." In the circumstances of this case, involving sale of commercial paper of a finance company, the investigation that Nuveen made (*see* pp. 5-6 *supra*) should have been found adequate under this or any other reasonable standard, even though it failed to detect the issuer's and its accountants' fraud. This is especially true

considering that numerous lending banks, including major ones located in the vicinity of the issuer, failed to detect the same fraud while presumably exercising reasonable care to protect their own funds.*

2. As a Consequence of the Court of Appeals' Decision, Concealed Fraud by the Issuer of Commercial Paper Would Preclude Exemption From the 1933 Act's Registration Requirement and Would Make Every Commercial Paper Dealer a Virtual Insurer

An unreasonable burden was placed on commercial paper dealers for still another reason, related to Part I above.

In reaching its decision that the short-term notes in this case were securities under the 1934 Act, the Court of Appeals relied upon material relevant to the 1933 Act's exemption for short-term notes.** In essence, the court's approach was that if the commercial paper in question was not an exempt security under the 1933 Act,*** it was not entitled to exclusion from the definition of security in Section 3(a)

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* The Court of Appeals seemingly acknowledged that if Nuveen's obligation were "to comply with the standard applicable to a broker-dealer who had recommended the purchase of a security" it would have met its duty by reliance on published data and would not have been required to discharge an additional duty of investigation (A. 9). *See also Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 371 (2d Cir. 1973), *cert. denied*, 414 U.S. 910, 924 (1973).

** *See* discussion in *Sanders I* (A. 55-57).

*** In contrast to the 1934 Act, the 1933 Act does not exclude short-term notes from the definition of security; rather, Section 3(a)(3) expressly exempts such notes from the registration requirements of that Act, by the following language:

> "3(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> • • •
>
> "(3) any note, draft, bill of exchange, or bankers' acceptance *which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions*, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited; . . ." (emphasis added).

The italicized language appears in the 1933 Act exemption but not in the 1934 Act definition.

(10) of the 1934 Act (A. 56). In so holding, the court not only took the unwarranted step of reading into Section 3(a)(10) of the 1934 Act a provision of Section 3(a)(3) of the 1933 Act (which led to a reading of Section 3(a)(10) opposite to that of the SEC's, *see Penn Central Report* at 273-274), but it then proceeded, petitioners submit, to misread the SEC's interpretation of the words thus improperly injected into Section 3(a)(10).

Specifically, the court below relied on *SEC Release No. 33-4412* (September 20, 1961), interpreting Section 3(a)(3) of the 1933 Act. Despite the fact that the release explicitly stated that "A type of security which usually has been considered to fall within the terms of Section 3(a)(3) is short-term paper issued by finance companies to carry their installment loans", the court below focused on the following language in the release:

> ". . . section 3(a)(3) applied only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks."

In interpreting and applying this paragraph, the court concluded that, although Winter & Hirsch's insolvency was not known to the petitioners at the time of sale of the paper, the fact of insolvency meant that the paper was neither "prime quality" nor "eligible for discounting" by federal reserve banks (A. 55-56).

Retracing the steps in the court's reasoning and applying this conclusion to the exemptive language of the 1933 Act, the effect would necessarily be that, where the issuer and its accountants are engaged in a massive fraud, in the event of the insolvency of the issuer the risk of liability under Sec-

tion 12(1) of the 1933 Act for the sale of unregistered securities (*i.e.*, the commercial paper which, in view of the insolvency, could not have been "prime quality") falls directly on the dealer, no matter how extensive the dealer's investigation.

The liability of sellers of securities under the express anti-fraud liability provision of the 1933 and 1934 Acts is, generally, not absolute but rather is dependent upon the extent of the seller's knowledge or investigation of the facts. *See, e.g.*, Sections 11 and 12(2) of the 1933 Act, Sections 9 and 18 of the 1934 Act. On the other hand, under Section 12(1) of the 1933 Act liability is virtually absolute. If by hindsight, after discovery of fraudulently concealed insolvency, a court can determine that the exemption from registration normally available to commercial paper was not available, then a questionable anti-fraud claim will become a virtually certain claim for the sale of unregistered securities.

If a court can thus retrospectively determine the status of commercial paper vis-a-vis the registration requirements, *i.e.*, if dealers in commercial paper must wait to see whether the paper is paid at maturity before they know whether an exemption from 1933 Act registration was available, they may be subject to liability without regard to the nature or extent of their investigation. This erroneous view of the prime quality and discounting aspects of *SEC Release No. 33-4412* interpreting Section 3(a)(3) would alone be sufficient reason for this Court to grant this petition for certiorari.*

* Petitioners should not be understood to accept *Release No. 33-4412* as being otherwise an accurate interpretation of Section 3(a)(3).

CONCLUSION

For the reasons given, petitioners pray that a writ be granted to review the judgment and opinion below. If the Court holds in *Ernst & Ernst* that *scienter* is a requirement of liability under Rule 10b-5, petitioners pray that the writ be granted and that the judgment below be summarily reversed.

Respectfully submitted,

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 74-2047, 75-1260

HENRY T. SANDERS,

Plaintiff-Appellee,

v.

JOHN NUVEEN & CO., INC.,
INVESTORS DIVERSIFIED SERVICES, INC.,
INVESTORS SYNDICATE OF AMERICA, INC., and
ALLEGHANY CORPORATION,

Defendants-Appellants.

Appeal from the United States District Court
for the Northern District of Illinois,
Eastern Division
No. 70 C 597
JOSEPH SAM PERRY, *Judge*

ARGUED JUNE 13, 1975—DECIDED OCTOBER 30, 1975

Before CLARK, *Associate Justice (Retired)*,* FAIRCHILD, *Chief Judge*, and STEVENS, *Circuit Judge*.

STEVENS, *Circuit Judge*. The principal question presented is whether an underwriter of short term commercial paper, who acted in the mistaken, but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default. The district court held the underwriter liable on the theory that it breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud. We affirm.

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* Tom C. Clark, Associate Justice (Retired) of the United States Supreme Court, was sitting by designation.

The plaintiff class consists of 42 purchasers of short term notes issued by Winter & Hirsch, Inc. ("WH"), a finance company that defaulted on its obligations on February 25, 1970. All of the plaintiffs' notes, totaling $1,612,500 in face value, were purchased from the defendant, John Nuveen & Co., Inc. ("Nuveen") during the period between June 30, 1969, and February 10, 1970.

Nuveen, whose primary business for many years had been the sale of tax exempt securities, entered the commercial paper business in September of 1968 by acquiring the assets of a commercial paper broker headquartered in Chicago. WH had been one of approximately 40 issuers represented by that broker. Without first making an investigation of the corporate affairs, business, or financial condition of WH, Nuveen began to underwrite and to sell commercial paper issued by WH.

Nuveen operated 17 branch offices located throughout the United States. Its entire sales force, including 172 registered representatives, was authorized to sell commercial paper. The paper which it sold, including the WH notes, was rated "Desirable" by a subsidiary of Standard & Poor,* in a system in which "Prime" was the highest rating and "Desirable" was the second category. The head of Nuveen's commercial paper department testified that the paper handled by Nuveen was sold on the basis "that there should be no question but what the paper will be paid at maturity."

Nuveen customarily prepared a credit report on the issues of commercial paper which it sold; such reports on WH were given to Nuveen's customers. At least some of the reports stated that they contained information derived from a "detailed audit" of WH.

* By order dated December 24, 1975, "a subsidiary of Standard & Poor" was deleted and "the National Credit Office" substituted therefor.

The district court found that Nuveen was an underwriter of WH commercial paper. During the period between September 1968 and February 1970, Nuveen purchased and resold substantially all of WH's short term discount notes.[1] The amount of outstanding indebtedness evidenced by such notes varied from about $1,500,000 to $4,000,000.[2] Nuveen sold WH paper to banks, insurance companies, individuals and firms throughout the United States. They were frequently "rolled over" at maturity; that is, new notes were accepted in payment of outstanding notes when they became due. The conclusion that Nuveen was an underwriter for WH is not challenged.

Nuveen made some investigation of the affairs of WH. It analyzed semiannual financial statements prepared by the certified public accounting firm of Lieber, Bleiweis & Company. Nuveen ascertained that a number of large banks had been extending millions of dollars of credit to WH for many years.[3] In March of 1969 a credit analyst employed by Nuveen spent a day at the offices of WH; he examined records relating to WH's accounts receivable and its collection procedures.

In September of 1969, Investors Diversified Services ("IDS"), through its wholly owned subsidiary, Investors

[1] The district court found that between September 1, 1968, and February 10, 1970, except for two notes in the face amount of $60,000, Nuveen purchased all the commercial paper issued by WH. Occasionally, as at the time of the default, Nuveen had some of WH paper in its own portfolio.

[2] Thus, the amount of WH commercial paper issued and outstanding in 1968 ranged from a low of $1,915,000 in January to a high of $4,064,500 in April. The amount outstanding at the time of the default in February 1970 was $1,661,500 in face value represented by 56 notes held by 44 different firms or individuals. One note was then held by Nuveen and another holder elected to opt out of the class. Accordingly, the 42 members of the class asserting claims in this litigation held a total of $1,612,500 in WH notes.

[3] Among those banks, with the amount of the line of credit for each bank, were The First National Bank of Chicago ($1,750,000), Chase Manhattan ($1,750,000), Continental Illinois National Bank and Trust Company of Chicago ($1,500,000), National Bank of Detroit ($1,250,000), Central National Bank of Chicago ($1,250,000), and Harris Trust & Savings Bank ($1,000,000).

Syndicate of America, Inc., acquired all the stock of Nuveen. The senior vice-president of IDS then became a director of Nuveen and a member of its Executive Committee, with special responsibility for the commercial paper operation. Thereafter, the head of Nuveen's commercial paper department had lunch with the president of WH, noticed that he appeared ill, and decided to conduct a check of WH. Accordingly, Nuveen personnel again reviewed the most recent Lieber, Bleiweis statements, and in mid-January of 1970, letters of inquiry were sent to 10 banks. The responses were either neutral or favorable.

Nuveen never made any request to examine WH's tax returns, its corporate minutes, or its contracts. Nuveen did not meet with any representative of Lieber, Bleiweis and made no request to see any working papers used in the preparation of its semiannual statements.

In January of 1970, two lenders who had heard rumors about the Lieber, Bleiweis audits of WH, insisted that WH retain a new accounting firm to conduct an audit as of January 31, 1970. The new accounting firm was retained on January 12, 1970. Those accountants promptly discovered that no federal income tax return had been filed for the fiscal year ended August 31, 1969; that Lieber, Bleiweis work papers were either not in existence or not available; and that the general ledger of WH could not be reconciled with the August 31, 1969, statement of net worth in the Lieber, Bleiweis audit. In due course, the accountants discovered a $14,000,000 deficiency in the accounts receivable and unrecorded indebtedness of $1,750,000. WH was hopelessly insolvent—a fact which had been concealed by the falsification of records by WH and Lieber, Bleiweis for a period of at least 10 years.[4]

[4] Ultimately, the principals of WH and Lieber, Bleiweis pleaded guilty in the federal district court to criminal charges and received jail sentences and fines.

On February 10, 1970, Nuveen first heard the rumors about WH and, as a result of inquiries, also learned that a fresh audit of WH was being made. Nuveen immediately ceased the sale of WH commercial paper and sold none thereafter. The WH notes then outstanding were not paid.

On March 12, 1970, plaintiff Henry T. Sanders filed this class action against Nuveen, the corporations directly and indirectly in control of Nuveen,[5] and nine individuals.[6] The complaint as amended principally alleged that the defendant Nuveen violated the federal securities laws by selling WH commercial paper without first making an investigation of WH sufficient to satisfy Nuveen's duty as an underwriter,[7] and the Rules of Fair Practice of the National Association of Securities Dealers, Inc., by failing to establish written procedures for the sale of commercial paper and failing properly to train and supervise its salesmen. The other defendants are alleged to be liable as "controlling persons" of Nuveen.

The district court denied defendants' motion to strike certain critical allegations and then certified to this court the question whether the WH commercial paper was a "security" within the meaning of the Securities Exchange

[5] The defendants, Investors Diversified Services, Inc., Investors Syndicate of America, Inc., and Alleghany Corporation, are involved only as alleged "controlling persons" with regard to Nuveen. Thus, they can be held liable under § 20 of the Securities Exchange Act, 15 U.S.C. § 78t, only if Nuveen is first found to be liable.

[6] Two defendants were dismissed by stipulation based on facts not known to the plaintiff at the time of filing suit. All remaining individual plaintiffs were dismissed without prejudice, with the approval of the district judge; in connection with the dismissal IDS guaranteed any judgment which might be entered against Nuveen.

[7] In particular, the amended complaint asserts claims under Sections 12(2) and 17 of the Securities Act of 1933, 15 U.S.C. §§ 771(2) and 77q; Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t; and Rule 10b-5 of the Securities and Exchange Commission, 17 CFR 240.10b-5.

Act of 1934. We answered that question in the affirmative[8] and remanded the case for trial.

After trial the district court made detailed findings of fact and entered judgment for plaintiffs. The court concluded that Nuveen had a duty as an underwriter to make a reasonable investigation of WH and that, in the circumstances of this case, such an investigation would have revealed the fraud. Defendants appeal, primarily contending that Nuveen acted reasonably and did not violate any statutory duty to its customers.

I.

Appeal No. 74-2047

We think appellants are correct in arguing that Nuveen's liability in this case must rest on Rule 10b-5.[9] Section 11 of the Securities Act of 1933 is inapplicable because no registration statement was filed,[10] and we do not rely on § 12(2) of that Act because the district court did not find any violation of that section.[11] We also agree with appel-

[8] *Sanders* v. *Nuveen*, 463 F.2d 1075 (7th Cir. 1972), *cert. denied* 409 U.S. 1009 (*Sanders I*). Defendant has asked us to reconsider that holding or, alternatively, to hold that the WH notes sold to banks by Nuveen were not securities even if notes sold to individuals were. Since the findings establish the factual basis for the conclusion expressed in *Sanders I*, the rationale of Judge Sprecher's opinion clearly requires rejection of both of these requests.

[9] "17 CFR § 240.10b-5. Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

[10] By its terms § 11 defines liability for misstatements or omissions in registration statements.

[11] Plaintiff argued on appeal that the credit reports on WH disseminated by Nuveen were prospectuses within the meaning of the Act. The district court made no such finding.

lants that the evidence does not indicate that all members of the class relied on express recommendations by Nuveen. Moreover, for purposes of decision we accept appellants' argument that the Lieber, Bleiweis audit was appropriately certified and nothing in the audits themselves gave Nuveen any special reason to question their accuracy.[12] Finally, we deliberately avoid any extended discussion of the broad question whether there is a generally applicable standard of culpability in Rule 10b-5 cases lying somewhere between the extremes of common law fraud on the one hand[13] and mere neglilgence on the other.[14] We assume the standard may be phrased differently in different circumstances.[15]

In this case, the result is controlled by a few critical facts. Defendant Nuveen was an underwriter of WH commercial paper. Although Nuveen was unaware of the fraud perpetrated by WH and Lieber, Bleiweis, a request to examine federal income tax returns, corporate minute books and accounting work papers—or indeed any one of these sources of information—would have revealed the fraud or at the very least would have revealed deficiencies that would have mandated further inquiry.

Nuveen's status as an underwriter is significant for two reasons. An underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published

[12] Nor need we decide whether plaintiff's losses could fairly be attributed to Nuveen's apparent violation of Rule 27 of the Rules of the National Association of Securities Dealers, Inc., requiring enforcement of written procedures for the sale of securities.

[13] The rationale of this circuit's selection of the appropriate state statute of limitations to apply to 10b-5 actions rests on the premise that 10b-5 authorizes recovery despite the absence of the kind of *scienter* necessary to sustain a common law fraud claim. See *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972).

[14] See *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974); *Bucklo, Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562 (1972).

[15] Even scholars searching for a generally applicable black letter rule acknowledge the need for specific exceptions based on the nature of a particular business relationship. See Bucklo, *supra*, n.14, at 595.

information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity,[16] independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security.[17] And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer.[18]

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[16] In *Feit* v. *Leasco Data Processing Corporation*, 332 F.Supp. 544, 581 (E.D.N.Y. 1971), the court noticed that:

> "The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing."

[17] In a case arising under § 14 of the 1934 Act, Judge Timbers wrote at length about the special responsibilities of underwriters, stating:

> "The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies.
>
> * * *
>
> "Self-regulation is the mainspring of the federal securities laws. No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. Since he often has a financial stake in the issue, he has a special motive thoroughly to investigate the issuer's strengths and weaknesses. Prospective investors look to the underwriter—a fact well known to all concerned and especially to the underwriter—to pass on the soundness of the security and the correctness of the registration statement and prospectus." *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d. Cir. 1973).

[18] Whether reviewing the underwriter's duty to investigate under the standards of § 11 applicable to registration statements or under the standards of Rule 10b-5, the following comment by Judge McLean is pertinent:

> "To effectuate the statute's purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them." *Escott* v. *BarChris Construction Corporation*, 283 F.Supp. 643, 697 (S.D.N.Y. 1968).

Nuveen argues that the underwriter's duty of disclosure is limited to "facts which he knows and those which are reasonably ascertainable."[19] That statement of the standard as applied to a broker-dealer would justify reliance an published data. But a greater quantity of information is "reasonably ascertainable" by an underwriter than by a mere broker, and something more than published data must be analyzed if an underwriter is to discharge his duty of investigation. In this case, the district court correctly found that Nuveen's investigation of WH was deficient and that an appropriate investigation would have revealed the fraud.

In reaching this conclusion we have taken into consideration the fact that the security was short term commercial paper rather than stock or long term indebtedness. The nature of this security minimized the investor's interest in the long range prospects of the issuer and therefore would justify a lesser consideration by the underwriter of such matters as growth prospects and dividend policies. On the other hand, the fact that the investor's concern was limited to the issuer's ability to pay its bills in the immediate future enhanced the importance of determining the basic integrity of the issuer's financial statements. Although the under-

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[19] As we understand Nuveen's argument, Nuveen would acknowledge an obligation to comply with the standard applicable to a broker-dealer who had recommended the purchase of a security. That standard was described as follows in *Hanly* v. *S.E.C.*, 415 F.2d 589, 597 (2d Cir. 1969):

> "In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information."

writer cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound.

Nuveen forcefully argues that its reliance on the Lieber, Bleiweis audits was reasonable because the leading banks in the country, which had extended millions of dollars of credit to WH over a period of many years, also relied on the same information (or misinformation). There are two answers to this argument. First, the reasonableness of a bank's credit investigation procedures is not before us and is not to be judged under the standards of the Federal Securities Acts; we are concerned only with the duty of the underwriter to comply with the requirements of statutes and regulations designed to protect the investing public. Second, even if we should assume that the banks are subject to the same standards as an underwriter, the fact that their practices may have been considered acceptable by the banking industry would not convince us that they meet the standards imposed by the relevant statutes and regulations.[20]

No doubt there are cases in which an issuer may perpetrate a fraud which will escape detection notwithstanding a reasonable investigation by an underwriter. Experience teaches us that fraud can be skillfully hidden. But this was not such a case. The indications of questionable practices by WH were easily accessible to a competent underwriter with a question of fraud in mind. Even though WH was an

[20] We recently quoted the following excerpt from Judge Hand's opinion in *The T. J. Hooper*, 60 F.2d 737, 740:

> "Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required: there are precautions so imperative that even their universal disregard will not excuse their omission."

See *Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1113 (1974).

old established firm with a fine reputation, that fact cannot justify the conclusion that an underwriter's investigation which entirely ignored the possibility of fraud was reasonable. The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality. The district court correctly concluded that Nuveen breached that duty.

II.

The three remaining defendants are corporations which have controlled Nuveen since September 15, 1969.[21] They are jointly and severally liable for Nuveen's violation unless they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation . . ." within the meaning of § 20 of the Securities and Exchange Act of 1934.[22] The "act" involved here is Nuveen's failure to make a proper investigation of WH.

The district court found that, following the acquisition of Nuveen on September 15, 1969, IDS caused its senior

[21] They are Investors Syndicate of America (ISA) which from September 15, 1969, until some time after the events in this case owned 100% of the stock of Nuveen; Investors Diversified Services (IDS), which owns all of the stock of ISA; and Alleghany Corporation, which owns more than 40% of the stock of IDS.

[22] That section provides:

> "§ 78t. Liabilities of controlling persons
>
> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.
>
> (c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information."

15 U.S.C. § 78t.

vice-president, Kenneth Wahlberg, to become a member of the board of directors of Nuveen, and a member of a three-man executive committee established to conduct and supervise Nuveen's operations. Wahlberg was experienced in buying commercial paper; Richard Frank, the executive vice-president of Nuveen, testified that Nuveen looked to Wahlberg for expert guidance and direction in conducting Nuveen's commercial paper operations.[23] In December, 1969, Wahlberg, as a member of Nuveen's executive committee, reviewed the commercial paper sold by Nuveen and participated in the committee's decision that Nuveen would continue to sell the notes issued by WH. These facts show a direct involvement by Wahlberg in the actual conduct found wrongful here—the underwriting of WH paper without conducting a reasonable investigation.[24] Since he was a senior executive acting on behalf of IDS and ISA, these corporations are liable as "controlling persons."

The situation is rather different as regards Alleghany Corporation. Alleghany is primarily an investor. Although it was in control of IDS by virtue of its 40% stock ownership and because officers and directors of Alleghany acted as officers and directors of IDS, it was never shown that Alleghany took any active part in the management of Nuveen; rather, it delegated this task to IDS. The judgment against Alleghany should therefore be reversed.

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[23] Wahlberg also testified that in October, 1969, instructions were given to hire a credit investigator in the commercial paper department as additional personnel Wahlberg felt was needed.

[24] This is a very different situation from that in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc). There, a partner in Drexel & Co., a securities dealer was a director of BarChris Construction Co. Officers of BarChris made certain misrepresentations to the plaintiff in arranging a merger of the plaintiff's company into BarChris. Plaintiff sought to hold Coleman liable as a director, and Drexel & Co. liable as his employer. However, Coleman was not present at the meeting where the misrepresentations were made, and he inquired of one of BarChris's officers who affirmatively misled him.

Here, Wahlberg, on behalf of IDS and ISA, was an executive with direct responsibility for the extent of Nuveen's investigation. Although he relied on Nuveen's "fine reputation," he knew what investigations were, or were not, actually being made.

III.

Appeal No. 75-1260

After entry of the judgment appealed from in No. 74-2047, the district court heard objections from defendants-appellants on issues relating to particular claims. On January 27, 1975, the district court entered a final order overruling all such objections not previously withdrawn or ruled upon. On February 21, 1975, defendants' notice of appeal on these issues was entered. We deal with these issues individually.

A.

Appellants contend that the district court erred in failing to require the individual members of the plaintiff class to show (a) whether they had received any recommendation or report from Nuveen on WH; (b) whether each class member's purchase represented a commercial or an investment transaction; and (c) the degree of knowledge which each class member possessed regarding WH at the time of purchase.

The disposition which we have made of the liability issue disposes of the first contention; as an underwriter selling the WH notes, Nuveen made an implied representation that it had reasonable grounds for belief that these notes would be paid at maturity. Of necessity, this "representation" was made to all purchasers from Nuveen. *Cf. Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 152-153, rehearing denied 407 U.S. 916 and 408 U.S. 931 (1972). Since it can fairly be inferred that no member of the plaintiff class would have bought the notes had he known, as Nuveen could easily have discovered, that WH's financial records were fraudulent, the representation was material and provides the basis for recovery by the entire class.

The appellants' contention that each of the banks which was a member of the plaintiff class should have been required to show that it acquired the note or notes in question as a result of an investment rather than a commercial transaction is also without merit. Plaintiffs have shown that these notes were acquired from Nuveen, and not as part of a direct loan transaction with WH. Since the notes were marketed as securities, see *Sanders I, supra,* at 1080, this is sufficient to bring the bank within the protection of the Securities Act. *Cf. Lehigh Valley Trust Co.* v. *Central National Bank of Jacksonville,* 409 F.2d 989, 992-993 (5th Cir. 1969).

Nor is it material, short of a showing of actual knowledge of the fraud, what knowledge any plaintiff had about WH. The unsophisticated and unwary are not the only beneficiaries of the federal securities laws. See, *e.g., Hill York Corp.* v. *American International Franchises, Inc.,* 448 F.2d 680 (5th Cir. 1971); *S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom Kline* v. *S.E.C.,* 394 U.S. 976 (1969). There has not been (save in the special case of National Stock Yards National Bank, discussed below) any suggestion that any plaintiff actually knew of the fraud at the time it purchased the securities.[25]

B.

The defendants object to recovery by National Stock Yards National Bank and Capitol Bank of Springfield on the grounds that (1) both are *in pari delicto* with Nuveen, and (2) as to National, it reacquired the notes after it had actual notice of the fraud. Neither of these objections is well taken.

[25] Since no showing of individual reliance or general ignorance of WH was required, the district court did not abuse its discretion in denying defendants' motion to serve interrogatories on certain members of the plaintiff class after judgment on the common issues.

National and Capitol purchased notes from Nuveen which they then resold to correspondent banks. However, it is clear that National and Capitol were acting as agents for their correspondent banks, and not as underwriters as was Nuveen.[26] Thus, they did not share Nuveen's duty to investigate and cannot be considered to be *in pari delicto* with Nuveen.[27]

Appellants also contend that National should be barred from recovering because it repurchased the notes after it had actual knowledge of the fraud.

National has filed a claim in this case as the holder of seven WH notes. National purchased those notes between November 1969 and January 1970 as agent for seven smaller banks for which it acted as correspondent. National paid Nuveen for the notes and either debited the accounts of the smaller banks for the amounts in question or was paid by them. National retained the notes for safekeeping. After being notified of the problem with WH, National repurchased the notes from its correspondent banks.

Appellants contend that National's repurchase of the notes after it had knowledge of the fraud bars it from recovery, apparently on the theory that any loss which National incurred was a result not of Nuveen's misconduct, but of National's knowing assumption of risk. If National had made its purchase *from Nuveen* despite knowledge of material adverse facts, the contention would have some force. But here National merely acted to protect the seven correspondent banks from loss on the notes which National

[26] National and Capitol made no "public distributions," they did not solicit orders for these notes, and they received no compensation for their services in purchasing them.

[27] Because we deem the *in pari delicto* issue to be meritless on the facts, we do not reach the question whether it was, in the circumstances, raised too late to be considered. Although the issue of *in pari delicto* goes to the question of liability, it was not an issue common to all members of the class.

had chosen for them. That action did not enlarge Nuveen's potential liability, but merely had the effect of substituting National for the seven banks as the injured party. To hold that National could not recover in this situation would be to frustrate the purpose of the securities acts to protect innocent investors—here, the seven correspondent banks—because it would tend to deter such repurchase by intermediate banks. Appellants have also argued, in attempting to put forward a defense of *in pari delicto,* that National had a legal duty to reimburse the correspondent banks. While we have found that National was not an underwriter, this does not foreclose the possibility that National was liable to its correspondents on some other basis. In that case, of course, National's loss would have been the same whether it voluntarily repaid the correspondents, or was forced to do so by legal action. In either case, National's loss was a direct result of Nuveen's sale of the notes without a reasonable basis to believe that they would be paid when due.[28]

C.

Appellants object to the claim of Dimmy Andrews on the ground that he had previously opted out of the action. The record shows that Andrews wrote a letter opting out; that he "intended" to send it to the court, although he could not remember whether it was actually mailed; that a carbon copy of the letter was sent to and received by Nuveen, but that there was no record of the letter ever

[28] Appellants also suggest that National cannot recover because it is not properly a member of the class, since it did not own the notes on February 23, 1970. However, National was always included in the list of class members and received all notices. Appellants did not raise the point until after the decision on the merits, so there was no opportunity to correct what may have been a self-contradictory class description. And in any case, exclusion of National from the class at this point would not defeat a separate action by National since the statute of limitations has been tolled during the pendency of the class action. *American Pipe & Construction Co.* v. *Utah,* 414 U.S. 538.

having been received by the court. There was also some evidence to show that Andrews decided to opt out on the advice of a Mr. Stuart, an employee of Nuveen. On these facts, the district court found that Andrews had not effectively opted out of the class.

With some misgivings, we conclude that the district court did not abuse its discretion in so holding. Courts have been flexible in recognizing elections to be excluded from a class which were communicated to the court, although not in the proper form. *In re Four Seasons Securities Law Litigation,* 493 F.2d 1288 (10th Cir. 1974); *Bonner* v. *Texas City Independent School Dist. of Texas,* 305 F.Supp. 600 (S.D. Tex. 1969). However, in this case, no communication was actually received by the court until after the adjudication on the merits. Thus, while the question is a close one in view of the obvious dangers of "one-way intervention," we cannot say that the district court exceeded its broad discretion.

IV.

Appellants argue that the award of prejudgment interest was erroneous because the trial court failed properly to weigh the equities between the plaintiffs and the defendants. It is true that the award of prejudgment interest is responsive to considerations of fairness. *Blau* v. *Lehman,* 368 U.S. 403, 414. But the imposition of prejudgment interest is in its origin a form of compensation, not a penalty. As the Supreme Court said in *Rodgers* v. *United States,* 332 U.S. 371, 373:

> As our prior cases show, a persuasive consideration in determining whether such obligations shall bear interest is the relative equities between the beneficiaries of the obligation and those upon whom it has been imposed. And this Court has generally weighed these

> relative equities in accordance with the historic judicial principle that one for whose financial advantage an obligation was assumed or imposed, and who has suffered actual money damages by another's breach of that obligation, should be fairly compensated for the loss thereby sustained.

Thus, if a defendant has deprived the plaintiff of a specific sum of money, he has also deprived the plaintiff of the interest which the money would have earned in the absence of defendant's breach of duty; unless the plaintiff is paid interest for the entire time that he is deprived of the use of his money, he will not receive full compensation.

Nevertheless, for various reasons it may be inequitable to impose such an extra payment on the defendant. For example, if final judgment is unreasonably delayed due to the actions of the plaintiff, interest should be suspended for the period of the delay. Or, if the interest would in effect act as a penalty on a relatively innocent defendant, the court has discretion to refuse to award interest. *Compare Blau* v. *Lehman*, 368 U.S. 403, with *Norte & Co.* v. *Huffines*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied Muscat* v. *Norte & Co.*, 397 U.S. 989.

In this case, the award of interest was proper. Plaintiffs suffered the loss of use of the money which they had invested in WH notes (except for the portion recovered from the WH Liquidating Trust). The extended delay between the loss and final judgment was not caused by any dilatory tactics by the plaintiffs. And there are no countervailing equitable considerations making the award unfair to Nuveen. It is true that Nuveen had no actual knowledge of the fraud, but we have nonetheless held that Nuveen is responsible for serious omissions in the performance of its statutory duty as an underwriter. Although Nuveen did

not receive the money which the plaintiffs lost, recovery is predicated on compensation of the victim, not on a surrender of unjustified profits. Nuveen aided in setting up the liquidating trust which gave partial recovery to the plaintiffs, but Nuveen has had the benefit of the trust in that all payments from the trust have reduced Nuveen's liability. The district court was thus correct in awarding prejudgment interest.

The rate allowed, however, was incorrect. In line with the underlying principle of compensation, the rate allowed should be chosen to reflect the rate which the money would have earned for the plaintiffs had defendants not breached their duty. The theory of this case is that if Nuveen had not breached its duty, plaintiffs would never have purchased the notes in question. Thus, the rate of interest on the WH notes cannot be a correct gauge of what the plaintiff's money would otherwise have earned. That rate is wholly speculative, and therefore the legal judgment rate should have been used.

For the reasons explained above, the judgment of the district court is AFFIRMED in part, REVERSED in part, and the cause is remanded to the district court for entry of judgment consistent with this opinion. The costs of this appeal are to be taxed in full against all defendants-appellants except Alleghany Corporation.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

IN THE

UNITED STATES DISTRICT COURT

For The Northern District of Illinois
Eastern Division.

HENRY T. SANDERS,
Plaintiff,

vs.

JOHN NUVEEN & CO., INC., et al.,
Defendants.

No. 70 C 597

JUDGMENT ORDER,
FINDINGS OF FACT AND CONCLUSIONS OF LAW

This action coming on for trial before the Court, upon remand to this Court for further proceedings not inconsistent with the Opinion of the Seventh Circuit Court of Appeals rendered herein on June 9, 1972, and the issues having been duly tried; and

This case having been established as a class action under Rule 23, Federal Rules of Civil Procedure, by order of this Court, dated October 19, 1972, and notice sufficient to bind those of the class who did not elect to be excluded having been sent to each member of the class, one person having elected to be excluded,

This Court makes the following Finding of Fact, Conclusions of Law and Judgment:

FINDINGS OF FACT

Plaintiff

1. Plaintiff brought this Complaint as an individual and class action on behalf of all purchasers of notes issued by WH and sold by Nuveen, asserting claims under and pursuant to the Securities Exchange Act of 1934 (15 U.S.C. § 78a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240, 10b-5, and the Securities Act of 1933, 15 U.S.C. § 77a, and the Rules of Fair Practices of the National Association of Securities Dealers. (Complaint, ¶ 1, Amended Complaint, ¶ 3.) This action was not brought collusively to confer jurisdiction which this Court would not otherwise have.

2. Plaintiff Henry T. Sanders, on January 29, 1970, purchased from John Nuveen & Co., Incorporated ("Nuveen") for his own account a note issued by Winter & Hirsch, Inc. ("WH") in a face amount of $35,000.00 for which plaintiff paid $34,245.31. (Stip. ¶ 19, PX 82 (1), Tr. 134.)

The plaintiff Sanders purchased the WH note from Nuveen with funds realized from the sale of a tax exempt bond. Nuveen purchased the WH note for Sanders as a holding device so that interest would be earned on the funds until a longer term investment suitable for his investment purposes became available. (Tr. 117-20.)

Defendants.

3. At all times material hereto Nuveen was engaged in the business of underwriting and distributing to investors, brokers and other dealers commercial paper, corporation bonds and stocks, U.S. Government securities, Federal Agency obligations, municipal bonds and tax exempt notes; except that Nuveen ceased selling corporation stocks in July, 1969. Nuveen also was the Sponsor-Underwriter of the Nuveen Tax-Exempt Bond Fund which is a series of closed-end registered investment trusts, the assets of which are invested in a diversified group of issues of municipal bonds. The Company maintained secondary market positions from time to time with respect to all of the above named investment media. (Stip. ¶ 5, PX 6.)

4. In September, 1968, Nuveen acquired the assets and business of Ashwell & Company, a commercial paper broker, and Nuveen commenced to underwrite and sell commercial paper. (Tr. 919-2, 225.) Prior to September, 1968, Nuveen had never handled or sold commercial paper. (Tr. 240, 341.)

5. On September 15, 1969, Investors Syndicate of America, Inc. acquired all the issued and outstanding voting stock of Nuveen. At all times material and relevant hereto Investors Diversified Services, Inc. ("IDS") was the sole stockholder of Investors Syndicate of America, Inc. Alleghany Corporation, a holding company, was the largest stockholder of IDS and owned beneficially over 40% of the outstanding voting stock of IDS. IDS was and is engaged in the business of mutual fund underwriting and as an investment adviser. (Stip. #6, PX 1, 2.)

6. Following the acquisition of all the outstanding stock of Nuveen, IDS caused its senior vice-president, Kenneth Wahlberg, to become a member of the board of directors of Nuveen, and a member of a three-man executive committee established to conduct and supervise Nuveen's operations. Wahlberg was experienced in buying commercial paper and Richard Franke, the executive vice-president of Nuveen, testified that Nuveen looked to Wahlberg for expert guidance and direction in conducting Nuveen's commercial paper operations. (Tr. 200-1.) In December, 1969, Nuveen's executive committee reviewed the commercial paper sold by Nuveen and made the decision that Nuveen would continue to sell the notes issued by WH. (Tr. 541.)

Winter & Hirsch, Inc.

7. The principal business of WH was financing the purchase of automobiles by members of the general public on both a discount and direct loan basis. Its business also included the financing of inventory of automobile dealers and direct consumer loans for various purposes. (Stip. #1.)

8. For the years ended August 31, 1968 and August 31, 1969, and for the six (6) month period ending February 28, 1969, WH issued financial statements purportedly audited by the certified public accounting firm of Lieber, Bleiweis and Company ("LB"), which statements were not in fact audited by LB or by any other firm of certified public accountants (Tr. 428), and which statements falsely, erroneously and inaccurately presented the financial condition of WH. (Stip. ¶ 2, 39, 41, 44, 55, 58; JX # 1, 2, 3; PX 21, 26.)

9. The business of a finance company such as WH is loaning money. WH obtained funds to loan from the following sources: capital invested by common and preferred stockholders; money loaned by banks in the form of unsecured bank lines of credit; long-term loans; subordinated loans from institutional lenders, such as insurance companies; and the sale of commercial paper. WH attempted to make a profit by lending funds out at a higher rate of interest than WH had to pay for its funds, either in the form of dividends or interest. The majority of the assets of WH were its accounts receivable and its liabilities were in the form of short term and long term senior debt, subordinated debt and short term notes generally in the form of commercial paper. (Stip. ¶ 3.)

10. The commercial paper of WH consisted of unsecured promissory notes payable to the bearer at a stated maturity of less than 270 days. WH issued these notes at a discount, without interest.

11. On November 10, 1969, J. Russell Hanson, an officer of the First National Bank of Chicago, a lender to WH,

received an anonymous telephone call in which the caller informed Hanson that the "WH statements were not right." Hanson telephoned officers of other lenders and discovered that William Zeh of the Lincoln National Life Insurance Co., and Floyd Smith of Mutual of New York had heard similar rumors. After numerous discussions with officers of other financial institutions, and with Milton Hirsch, President of WH, and with Bleiweis of LB, and after a preliminary examination of WH by an investigator named Tom McGinn, who was retained by Lincoln National Life Insurance Company, various lenders to and creditors of WH prevailed upon WH to retain the certified accounting firm of Peat, Marwick and Mitchell ("PMM") to do a full audit of WH. PMM was so retained on January 12, 1970. (Stip. 24 through 33.)

12. On January 11, 1970 Bernard Wiczer, an attorney for WH, told Hanson that Yale Izaks, executive vice-president of WH, had stated that the books of WH had been manipulated and that two other officers of WH were implicated. Yale Izaks left the employ of WH on Januray 11, 1970. (Stip. ¶ 30, 35; Tr. 61.)

13. Auditors and agents employed by PMM to audit WH discovered the following:

(a) On January 14, 1970 it was determined that WH had not filed a federal income tax return for the year ended 8/31/69, and had not obtained an extension of time for filing the return. (Stip. ¶ 37; PX 23.)

(b) On January 15, 1970 it was discovered that the work papers on which the 8/31/69 financial statements were prepared were not available; the journal for year-end adjustments was not available; and the general ledger of WH could not be reconciled to the 8/31/69 statement of net worth in the WH financial statements. (Stip. ¶ 38.)

(c) On January 19, 1970 PMM discovered that WH had not been able to prepare the 11/30/69 quarterly financial statement required by WH long-term debt agreements. (Stip. ¶ 38; PX 22.)

(d) On January 23, 1970 PMM discovered that the work papers of LB for their 8/31/69 audit of WH were virtually non-existent, and that LB had not audited WH in recent years. (Stip. ¶ 39.)

14. In auditing WH, PMM found the following:

(a) WH had experienced in excess of ten years of misstated financial statements and manipulations. (Stip. ¶ 41.)

(b) WH had not balanced its receivables to its ledgers. WH listed its receivable accounts every six months but the sheets were merely turned over to Yale Izaks and were never seen again. (Stip. ¶ 42; PX 27.)

(c) There was a discrepancy of $14 million between the actual WH accounts receivable and the WH ledgers. Since at least 1961 WH had increased the amount of receivables shown on its control ledgers and financial statements over the amount of WH's actual receivables. (Stip. ¶ 55.)

(d) Bank loans totalling $1,750,000 had not been entered on the WH books. This discrepancy was traced back to the audit date of 8/31/69. (Stip. 55.)

(e) Prior to February 6, 1970, WH had not filed its federal income tax return for its fiscal year ended August 31, 1969, and had not obtained an extension of time in which to file said return. That application for an extension of time was filed by PMM between February 6 and 13, 1979. (Stip. ¶ 46 through 48.)

(f) LB made no audit or write-up on WH internal control procedures; LB had no work papers used to reconcile the receivables trial balance to the general ledger control accounts. LB had allowed WH personnel

to control the selection of WH accounts receivable to be confirmed. (Stip. ¶ 39-42.)

15. On February 24, 1970, a meeting of the creditors of WH, each of whom had lent in excess of one million to WH, was held at the First National Bank of Chicago. Nuveen attended that meeting on behalf of all holders of WH commercial paper sold by Nuveen. A temporary creditors' committee was established with James Stewart of Nuveen as one of the members of the committee. All lenders were requested to forebear from any and all collections from WH until a permanent plan could be worked out. (Stip. ¶ 55, 56.)

16. On February 25, 1970, the president of WH telegraphed all its lenders and advised them that WH was suspending all payments on its debt. (Stip. ¶ 56.)

17. A permanent creditors' committee of WH was established March 11, 1970. (PX 32.)

18. At the time WH ceased paying its debts there were outstanding 56 short term notes issued by WH and sold by Nuveen, totalling $1,661,500 in face value, and these notes were held by 44 different firms or individuals. (PX 59.) One of the notes was held by Nuveen. The other 43 holders are members of the plaintiff class and were given notice of this action. One class member has opted out, and 42 members remain in the class, holding a total of $1,612,500 par or face value of WH short term notes. (PX 59, 66.) Each such WH note was sold by Nuveen during the period 6/30/69 to 2/10/70. (PX 37.)

19. On March 23, 1970, Mr. Jay Beckley, secretary of the creditors' committee, made a written report entitled "First Report of Creditors Committee of Winter & Hirsch, Inc." which was sent to the creditors of WH. (PX 35.)

20. At a meeting of the shareholders of WH held September 2, 1970, the shareholders adopted a plan of distribution of the assets of WH proposed by the creditors' committee of WH, and authorized the sale of the property and assets of WH to Mercantile Financial Corporation. (PX 42.)

21. As of September 31, 1970 the creditors of WH established a Liquidating Trust with Chicago Title & Trust Company as Trustee. The purpose of the Liquidating Trust was to collect all the assets of WH, and to distribute those assets to the creditors under a formula set forth in the Liquidating Trust. (Stip. ¶ 66, PX 92.)

22. All WH lenders were requested to execute a Consent Agreement relative to the establishment of the trust. An Advisory Committee to the Liquidating Trust was established. The Liquidating Trust, with the advice and consent of the Advisory Committee, was given the task of converting the assets of WH to cash and providing for distribution to the creditors on at least a semi-annual basis. (Stip. ¶ 67.)

23. Nuveen solicited consents to the WH Liquidating Trust from the holders of WH commercial paper upon the representation that such consent would not constitute a waiver of any rights the holders of WH commercial paper may have against Nuveen. (Stip. ¶ 68, PX 12 through 16, 37.)

24. Nuveen strongly recommended to the holders of WH commercial paper that they consent to the plan of distribution and the Liquidating Trust of WH. (Stip. ¶ 69; PX 49.)

25. Nuveen advised commercial paper holders that the trustee of the WH Liquidating Trust would make distribution to WH commercial paper holders of liquidating

dividends only to those holders who had consented to the Liquidating Trust and who had surrendered to the Chicago Title and Trust Company their WH notes to be held for safekeeping. (Stip. ¶ 70; PX 64a through o.)

26. Since the establishment of the Liquidating Trust, and since the filing of this lawsuit, Nuveen has received numerous inquiries from various holders of commercial paper, and others, which inquiries were answered by Nuveen. (Stip. ¶ 72, 73; PX 19, 47, 50-52.)

27. Henry T. Sanders, the plaintiff in this action, refused and has continued to refuse to consent to the Liquidating Trust of WH. Under date of December 16, 1970 Mr. J. R. Hanson, Chairman of the WH Creditors Committee, solicited the consent of the lenders to a first amendment to the WH Liquidating Trust, dated as of December 15, 1970. That amendment provided, *inter alia,* that the WH note held by plaintiff Henry Sanders could be paid in full by the Liquidating Trust. (Stip. ¶ 75, PX 41.)

28. The WH Liquidating Trust became effective on February 11, 1971. The Trust has made several distributions to creditors of WH, including holders of WH short term notes, but those notes have not been paid in full and various amounts remain unpaid on the notes. (Stip. ¶ 77.)

29. The plaintiff Henry T. Sanders, has received no distribution from the Liquidating Trust (Stip. ¶ 82), nor any payment from Nuveen on the WH note held by him, even though plaintiff made demand for such payment from Nuveen. (Stip. ¶ 23, Tr. 139.)

The Underwriting And Sale of WH Commercial Paper By Nuveen, And The Commercial Paper Operations Of Nuveen.

30. Nuveen made no examination or investigation of the corporate affairs, business or financial condition of WH prior to the time Nuveen commenced to underwrite and sell commercial paper issued by WH (Tr. 415), or by any other issuer. (Tr. 202, 230-1, 358.) WH had been an account of Ashwell & Co. and Nuveen simply took over the account. (Tr. 307.) Prior to the acquisition of its business and assets by Nuveen, Ashwell & Company had not made any independent examination or investigation of the financial condition or corporate affairs of WH. (Tr. 230.)

31. Prior to July, 1969 Nuveen, together with its affiliate Nuveen Corporation, employed 172 registered representatives to sell securities, including commercial paper, and Nuveen operated 17 branch offices located throughout the United States. Nuveen was not engaged in any non-securities business. (Stip. ¶ 7, PX 2, 4; Tr. 208, 340.)

32. From September, 1968 until February 10, 1970, except for two notes issued by WH in a total amount of $60,000.00, Nuveen purchased all the commercial paper issued by WH, and either held in inventory or resold that paper to banks, insurance companies, persons and firms throughout the United States. In selling and delivering the commercial paper of WH, Nuveen made use of the U.S. mails and other instrumentalities of interstate commerce. (Stip. ¶ 10, Tr. 190, 303.) Nuveen purchased WH notes at a discount and then offered and sold the notes to buyers at a lower discounted rate, or higher price, in order to realize a profit. The buyer was thus able to generate a return on his investment, and Nuveen was able to realize a profit from the sale of the notes. The trading securities ledgers of Nuveen show that very often WH notes were 'rolled over' by Nuveen, i.e., at the due date of the notes new notes were issued to the buyer in payment of and to replace the old due notes. (PX 45, 88, 89.)

33. From September, 1968 through December, 1968, Nuveen purchased from WH and sold to other parties, or held in its inventory, commercial paper of WH in total amounts outstanding which ranged from a low of $2,618,000.00 in December 1968 to a high of $2,890,000.00 in October, 1968. (Stip. 14, PX 44.) In the year 1968 there was issued and outstanding commercial paper of WH in total amounts which ranged each month from a low of $1,915,000.00 in January, 1968, to a high of $4,064,500.00 in April, 1968. (Stip. 14.) From January 1, 1969 to June, 1970 Nuveen purchased $9,171,500.00 face value of WH discounted notes which Nuveen sold for $9,305,500.00. (Defs' Ans. to Interrogatory # 3.)

34. Nuveen maintained a trading security ledger for each piece of commercial paper of WH sold by it and recorded each sale of WH commercial paper, and each cancellation, exchange or extension thereof. (Stip. ¶ 15, 16; PX 45, 74, 75, 88, 89.)

35. In the period 12/1/68 to 12/31/69 Nuveen realized a gross profit from its dealings in commercial paper of $410,415. (Stip. ¶ 7, PX 3.) Over half of the WH notes sold by Nuveen were purchased by individuals or were purchased for the accounts of individuals. Other purchasers were banks and insurance companies.

36. The number of issuers of commercial paper turned over to Nuveen by Ashwell was approximately 40 (Tr. 367), and while Nuveen was in the business of selling commercial paper it sold the commercial paper of 40 to 50 issuers at any one time. (Tr. 407.)

37. At no time while Nuveen was in the business of selling commercial paper did Nuveen adopt or promulgate any written procedures, instructions or directives for the sale of commercial paper. (Tr. 190, 199, 531.) Nuveen

traded in commercial paper in the same manner it traded in other securities handled by it. (Tr. 234.) While the entire Nuveen sales department was authorized to sell commercial paper, the only instructions given to Nuveen salesmen with reference to the sale of commercial paper occurred on a Sunday morning in October, 1968, during a week-end conference of all Nuveen's salesmen. (Tr. 349-50.) While Nuveen did not establish or adopt any system of rating the commercial paper sold by it (Tr. 203, 241), the system of rating commercial paper followed by the National Credit office ("NCO"), a subsidiary of Standard & Poor, was explained to the Nuveen salesmen. (Tr. 240.)

37A. Richard Franke, the executive vice president of Nuveen testified that Nuveen salesmen did not have enough knowledge to sell commercial paper on a day-in day-out basis. (Tr. 210.) Yet, after the first 60 days that Nuveen began selling commercial paper most of Nuveen's salesmen sold commercial paper to their customers directly. (Tr. 239.)

38. Nuveen established no written criteria or standards as to the financial condition, size, or worth to be met by issuers whose commercial paper was sold by Nuveen, and Nuveen and no standards or criteria which it followed in determining when or whether Nuveen would cease selling the commercial paper of an issuer. (Tr. 198.) Nuveen had no written or verbal requirement that issuers of commercial paper have audit reports certified by a certified public accountant. (Tr. 214, 223.)

39. Nuveen customarily prepared a credit report on issuers of commercial paper sold by Nuveen (Stip. ¶ 12), and these reports were given to buyers or potential buyers of commercial paper from Nuveen. (PX 11, 30, 97; Tr. 128.) Other than the credit reports, Nuveen did not advise its

salesmen to give buyers of commercial paper any information concerning the financial condition of the issuers of commercial paper being sold to that buyer, or to inform the commercial paper buyer of the rating of the commercial paper Nuveen sold to the buyer. (Tr. 125, 127-8, 250 PX 97.) Nuveen sold commercial paper on the basis, in the words of the head of Nuveen's commercial paper department, Dale Daniels, "that there should be no question but what the paper will be paid at maturity." (Tr. 339.)

40. All of the commercial paper sold by Nuveen, including that issued by WH, was rated "Desirable" by NCO, in a rating system in which "Prime" was the highest quality category and "Desirable" was the second quality category. Nuveen handled or sold no commercial paper rated Prime by NCO. (Tr. 203, 536.)

40A. A. G. Becker and Company, ("Becker") a brokerage firm and a dealer in commercial paper, sold WH notes for a period from 1965 to 1967. Becker ceased selling WH notes in 1967 because WH paper was not 'prime' and it was not desirable and profitable to deal in notes rated "Desirable", and because WH issued a relatively small amount of commercial paper. (Tr. 380-3.)

41. There is no evidence or testimony that anyone employed by or connected with Nuveen ever examined the corporate minutes or records of corporate actions of WH. The corporate minutes of WH had not been reviewed by WH's auditors since 1966 and were in "very poor shape." (Stip. ¶ 46.)

42. Commencing November 1, 1968 Nuveen hired David A. Vermeer to investigate the credit of the issuers of commercial paper sold by Nuveen. (Tr. 196.) Until July, 1969, Vermeer was solely responsible for investigating the credit of all the issuers of commercial paper sold by Nuveen.

(Tr. 196-7, 387.) Vermeer estimated that he spent 80% of his time checking the credit of issuers of commercial paper and 20-25% of his time on other activities. (Tr. 413.)

43. In checking the credit of an issuer of commercial paper, Vermeer examined the issuer's audit reports and the NCO reports on the issuers that were in Nuveen's files. (Tr. 397.) To some extent Vermeer relied on the NCO reports. (Tr. 398.) Vermeer would also address credit inquiries concerning WH to banks which were lenders to WH. Vermeer testified that the replies from banks did not tell anything about the actual financial strength of the company. (Tr. 619.) Dale Daniels, who was in charge of Nuveen's commercial paper department from October, 1969 to June, 1970, when Nuveen discontinued its commercial paper operations, confirmed Vermeer's testimony, stating, "You don't get a credit evaluation out of banks". (Tr. 352.)

44. Vermeer analyzed the audit reports received by Nuveen from issuers of commercial paper sold by Nuveen and from them computed some 30 ratios—debt to capital, receivables to loans, income to investment, etc.—and he entered all these rations in sheets called "spread sheets". (Tr. 389-90; JX 4, Tr. 579-80.) This was Nuveen's usual procedure in checking credit of an issuer. (Tr. 350.) The audit reports were analyzed only for the purpose of computing the ratios, and not for the purpose of checking the accuracy of the audit reports. (Tr. 406.)

45. Vermeer also made on-site inspections of the premises of finance companies whose commercial paper Nuveen sold, and examined some of their records, primarily to determine whether their notes receivable were legitimate. (Tr. 580.) Vermeer also reviewed with the senior officers of the finance company accounting collection and repossession procedures. (Tr. 580.) Vermeer would spend one or two days

at the offices of the issuer and write a report of his visit which was placed in Nuveen's files. No on-site inspection was made by Vermeer, or by anyone else at Nuveen prior to or at the time Nuveen commenced to sell the commercial paper of an issuer. (Tr. 415, 202, 230-1, 358.)

46. Nuveen obtained its credit information on WH from audit reports prepared by LB. (Tr. 406, 212, 359, 362, 230.) Nuveen's personnel did not know and had never met anyone at the accounting firm of LB. (Tr. 244, 401.) Nuveen never addressed any inquiries to LB. (Tr. 244, 406.)

47. Vermeer first worked on the WH account in December of 1968 when he spread the ratios for three years from WH financial statements. (Tr. 389.) He used the figures from the 8/31/68 audit of WH by LB and wrote a report on WH based on the computation of ratios from the WH audit reports.

48. In March, 1969, Vermeer visited WH's offices. Vermeer examined the accounts receivable cards of WH and the actual notes receivable, for the purpose of determining whether the receivables were good, how much delinquency on payments existed, and whether the receivables were aged properly. (Tr. 605-9.) Vermeer had lunch that day with Hirsch and Izaks.

49. Vermeer did not examine any internal control or accounting records of WH (Tr. 394), or the records of WH's payables and liabilities. Nor did Vermeer examine any corporate minutes of WH. (Tr. 394.)

50. In July, 1969 Vermeer was discharged by Nuveen. While Richard Franke testified that Vermeer was released because he was not a "self-starter" and was not busy enough (Tr. 196-7), Vermeer's discharge by Nuveen coincided with the release of some 200 employees by Nuveen and by discontinuance of Nuveen's stock or equity trading sales department. (Tr. 195.) Their discharges resulted in part from financial difficulties and large losses in Nuveen's bond department due to the tight money situation. (Tr. 346.) Vermeer was not replaced. (Tr. 197.)

51. By November 15, 1969 Nuveen had reduced its operations to 13 branch offices and had greatly reduced the number of its employees. (Stip. ¶ 8, PX 6.)

52. Donald Reid, the head of Nuveen's commercial paper department since September, 1968, assumed the credit checking responsibilities Vermeer had fulfilled. Reid testified that he was over-burdened and did not have time to do credit investigations. (Tr. 236.)

53. Reid officed in Chicago, Illinois, and had direct contact with all issuers of commercial paper sold by Nuveen which were located west of Ohio. (Tr. 307.) Dale Daniels officed in New York and had direct contact with all issuers whose rates Nuveen sold which were located east of Ohio. (Tr. 237.) The offices of WH were located in Chicago and came under Reid's supervision.

54. Reid left Nuveen at the end of October, 1969 and Dale Daniels became the head of Nuveen's commercial paper department in November, 1969. (Tr. 308, 340.) Reid assigned as one of his reasons for leaving Nuveen the fact that IDS, which had acquired all the stock of Nuveen, through its wholly-owned subsidiary, Investors Syndicate of America, would not honor his request for additional people. (Tr. 244.)

55. Wahlberg testified that instructions were given in October, 1969, to hire a credit investigator in the commercial paper department, not to replace Reid, but as additional personnel Wahlberg felt was needed. (Tr. 532.)

Wahlberg further testified that he knew Daniels was not familiar with the account handled by the Chicago office, and that is why Nuveen needed a new credit man. (Tr. 533.) Even though Nuveen had no written policies or directives with reference to commercial paper (Tr. 531), Wahlberg assumed Nuveen's methods were good because of Nuveen's fine reputation. (Tr. 531-2.) Franke testified Nuveen relied on Wahlberg for expertise in commercial paper operations. (Tr. 200-1.)

56. In December, 1969, Nuveen hired Richard Ferreira as a credit investigator in its commercial paper department. (Tr. 205.) From that date to June, 1970, when Nuveen ceased selling commercial paper, Ferreira was the only person at Nuveens involved in checking credit of commercial paper issuers. (Tr. 367-8.) A month after Reid left, the Nuveen commercial paper department consisted of Daniels, Ferreira, and two sales ladies. (Tr. 367-8, 207.)

57. Ferreira analyzed the issuers' audit reports and examined the NCO reports, and brought Vermeer's spread sheets up to date. (Tr. 359, 365.) Ferreira made no on-site inspections in the six months he was with Nuveen. (Tr. 358.)

58. Commencing in December, 1969, Daniels made a whirlwind tour to familiarize himself with the commercial paper issues handled by Nuveen's Chicago office. (Tr. 307.) In late December, 1969 Daniels had lunch with Hirsch in Chicago, primarily to establish contact with WH. (Tr. 310-11.) Daniels noted that Hirsch looked ill and ordered Ferreira to do a credit report on WH. (Tr. 310-11, 313, 365.)

59. Before Ferreira was employed by Nuveen in December, 1969, he had never analyzed the credit of an issuer of commercial paper. (Tr. 357.)

60. Ferreira did not visit the WH offices (Tr. 365), meet or talk with WH personnel or examine any WH records. (Tr. 358.)

61. Ferreira prepared a credit report on WH dated January 12, 1970. (PX 11.) For that report Ferreira used only the 8/31/69 LB audit statement on WH. (Stip. ¶ 12, Tr. 361-2.) Ferreira reported that the LB audit statement was a "detailed audit" of WH. (PX 11.) In the comment portion of WH's 8/31/69 audit LB stated they had not made a detailed audit (JX 3) and the NCO reports on WH noted that the WH audits were not detailed audits. (JX 5, PX 30, PX 100.) When the comments of the auditor in the 8/31/69 WH statement were brought to his attention, Ferreira testified that in his opinion the audit was uncertified. In his report on WH, Ferreira rated the commercial paper of WH as "Desirable," (PX 11)—the same ratio given WH paper by NCO. (JX 5, PX 30, PX 100.)

62. Ferreira made no credit inquiries of banks or other lenders to WH prior to writing his 1/12/70 report on WH. On January 22, 1970, at the urging of Daniels, Ferreira sent inquiries on WH to a dozen banks. (DX 3-9.) Three of the banks did not reply to Ferreira's credit inquiries (Tr. 370-1), of which at least two were fully aware of the investigations of WH undertaken by WH's lenders. On February 10, 1970, Verne Istock of the National Bank of Detroit, who had returned from a vacation, telephoned Nuveen and ultimately reached Daniels and told Daniels of the investigation of WH. (Tr. 497.) Istock suggested that Daniels talk with Hanson of the First National Bank of Chicago (one of the banks that had not responded to Ferreira's inquiry). Daniels did so, was informed of the investigation and audit of WH, and on February 10, 1970, Nuveen suspended the sale of WH commercial paper.

63. Upon the recommendation of Daniels, Nuveen stopped dealing in commercial paper in June, 1970. Daniels gave as his reasons for the discontinuance that he felt he was a commercial paper operator in a bond house, and he felt uncomfortable. (Tr. 3.) Daniels testified he had neither the support nor the technical operation necessary to run a commercial paper operation (Tr. 344) and that he "never felt that John Nuveen & Company was a company to do its job in commercial paper . . ." (Tr. 343.)

General

64. The market for commercial paper in the United States underwent a great expansion during the period from 1964 to 1972. Reid estimated that the amount of commercial paper outstanding grew from $8 billion to $40 billion in that period. (Tr. 251.1.) Wahlberg estimated the growth as from $6 billion to $40 billion. (Tr. 535.)

The Lieber and Bleiweis Audit Reports on Winter and Hirsch, Inc.

65. The WH audit reports prepared by LB for the years ended 8/31/68 and 8/31/69 (JX 1, 3), and the report for the six month period ended 2/28/69 (JX 2) are "long form reports" i.e., the audits contain a description of the methods, procedures and scope of the examination conducted by the auditors, as contrasted with a short form report which is a statement that the auditors' investigation was made in accordance with generally accepted auditing standards. (PX 95.)

66. In the WH audit reports which are relevant here, and which were furnished by WH to Nuveen, and on which Nuveen relied in determining the credit-worthiness of WH, LB made the following comments, among others:

(a) "Our examination was directed to the verification of the financial condition of the company at [date] and included a general review of the income and expense accounts, but without detailed audit of the transactions the year then ended." (JX 1-3.)

(b) "Requests for verification [of accounts receivable] were mailed during the period under review to all of the debtors in accordance with company policy whereby all accounts are circularized by management three times per year." (JX 1, 3.)

(c) "Provision for federal income taxes for the current year is based upon current rates including provision for applicable tax surcharge."

(d) "In our opinion, based upon the foregoing comments, the accompanying consolidated balance sheet and related consolidated statements of income and expenses and surplus present fairly the financial condition of Winter and Hirsch, Inc. . . . at [date] and the results of its operations for the year then ended, in conformity with generally accepted accounting principles . . ." (JX 1, 3.)

67. The statement set forth in ¶ 65(a) above is descriptive of an attempt to determine a balance sheet for WH at a given point in time, and is not a statement that the auditor attempted to determine the results of operations of WH. (Tr. 70-1.)

68. From the statement set forth in ¶ 65(b) above it cannot be determined who circularized the accounts receivable, management or the auditor. (Tr. 74-6.)

69. The statement set forth in ¶ 65(a) above to the effect that the auditor's examination is "without detailed audit of the transactions for the year then ended" does not indicate that the auditor had audited any or some of the transactions of WH. (Tr. 70-3.) Reid testified that such language is not usual or consistent with a good or unqualified audit report.

(Tr. 243.) Ferreira testified that this language meant that the audit was not a certified audit. (Tr. 364.)

70. The phrase, "based on the foregoing comments" which precedes the auditor's opinion (¶ 65(d) above) is unusual language in a certified audit. (Tr. 69-70.) That phrase is not gratuitous, appearing in an auditor's report, and the "comments" to which reference is made in the auditor's opinion are not gratuitous. (Tr. 559.) The effect of the phrase is that the comments which precede the opinion must be examined to determine the validity or qualification of the auditor's opinion. (Tr. 562.)

71. The statement set forth in ¶ 65(c) above, appearing in the auditor's report, is meaningless and gives no indication of the status of the tax filings of WH or the correctness of the provision for taxes contained in WH's financial statements. (Tr. 76-7.)

72. There is no statement in the WH audit reports, JX 1, 2 or 3, that the auditors tested the internal control records of WH. (Tr. 72, 78.) It was by manipulation of the control records—ledgers, summaries of receivables and payables—that WH effected a fraud upon its creditors, including the holders of notes issued by WH.

CONCLUSIONS OF LAW

C-1. This Court has jurisdiction over the parties and over the subject matter of this action under the Securities Act of 1933, 15 U.S.C. § 77a, and the Securities Exchange Act of 1934, 15 U.S.C. § 78a.

C-2. The notes issued by WH and sold by Nuveen to the plaintiff class are securities as that term is defined in § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) and § 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c

(a)(10). *Sanders* v. *Nuveen*, 463 F.2d 1075 (7th Cir. 1972), cert. denied 409 U.S. 1009 (1972).

C-3. The notes issued by WH and sold by Nuveen were not prime quality negotiable commercial paper, and were sold by Nuveen in interstate commerce and by use of interstate facilities to the general public for investment purposes.

C-4. Nuveen was an underwriter of the notes issued by WH and purchased by the plaintiff class. 15 U.S.C. § 77b and § 77k. *S.E.C.* v. *Van Horn*, 371 F.2d 181 (7th Cir. 1966). Nuveen also was a dealer in WH notes.

C-5. An underwriter of securities sold in interstate commerce or by use of interstate facilities has an obligation to disclose to the buyer all material facts affecting the value of the security, and not to misrepresent the security sold. *Escott* v. *Barchris*, 283 F.Supp. 643 (S.D.N.Y. 1968).

C-6. It was the duty of Nuveen, under § 11 of the Securities Act, 15 U.S.C. § 77k, and under § 10b of the Securities and Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, to make an investigation of WH calculated to reveal all facts material to an informed investment decision by a reasonably prudent investor, and to enable Nuveen to form a belief as to the accuracy of the representations made by WH, and to have reasonable grounds for a belief that the financial condition of WH was such that WH would have the ability to pay its notes as they matured. *Feit* v. *Leasco Data Processing Equipment Corporation*, 332 F.Supp. 544 (E.D.N.Y. 1971); *S.E.C.* v. *Goldman, Sachs & Co.*, CCH Fed. Sec. L. Rep. ¶ 94, 556 (S.D.N.Y. 1974).

C-7. In determining whether an underwriter has conducted a reasonable investigation and has formed a reasonable ground for belief as to the truth of the representations

and financial condition of the issuer, "the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 U.S.C. §77d(c).

C-8. A reasonable investigation of WH by Nuveen required a first-hand examination of WH's corporate records, loan agreements, income tax returns and accounting records by Nuveen, as well as inquiry of WH's auditors concerning the audits purportedly made by them. *Chris Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2nd Cir. 1973); *Feit* v. *Leasco, supra; Escott* v. *Barchris, supra.*

C-9. Nuveen failed to make a reasonable investigation of the corporate and tax affairs and the financial condition of WH and is therefore equally liable with WH to purchasers of WH notes sold by Nuveen for the fraud perpetrated by WH and the failure of WH to pay when due the WH notes sold by Nuveen. *Escott* v. *Barchris, supra.*

C-10. As a dealer in the notes of WH Nuveen had a duty to properly analyze the statements and audit reports of WH, to investigate the reliability and accuracy of those statements, and to form an adequate basis for recommending or selecting WH paper for purchase by members of the plaintiff class. *Hanly* v. *S.E.C.*, 415 F.2d 589 (2nd Cir. 1969).

C-11. The audit reports for WH prepared by LB, and sent to Nuveen, contained comments by the auditors which should have prompted inquiry by Nuveen as to the competence and reliability of the auditors and of the audit statements, and should have raised doubts and suspicions on the part of Nuveen as to whether the auditors had followed generally accepted auditing standards and procedures.

C-12. The WH audit reports prepared by LB and sent to Nuveen contained comments by the auditors that were so unusual and qualified, and so ambiguous with reference to subjects such as tax liabilities and filings, and verification

of accounts receivable, that a prudent investor could not reasonably rely upon them without making further inquiry and investigation.

C-13. The analysis of the WH audit reports made by Nuveen was inadequate and erroneous and Nuveen was negligent in failing to investigate and verify the auditing procedures followed by LB in preparing the WH audit reports sent to Nuveen and the accuracy and reliability of those reports. Nuveen's reliance on the WH audit reports was unreasonable and unwarranted.

C-14. Under Rule 27 of the Rules of the National Association of Securities Dealers ("NASD") Nuveen had an obligation to establish, maintain and enforce written procedures for the purchase and sale of WH notes, and other commercial paper, and for the adequate and proper supervision by Nuveen of personnel employed by Nuveen and engaged in the purchase and sale of commercial paper, and to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder, and with the Rules of the NASD. *S.E.C.* v. *First Securities Company of Chicago*, 463 F.2d 981. (7th Cir. 1972.)

C-15. Nuveen failed to establish, maintain or enforce written procedures, or non-written procedures for the purchase and sale of commercial paper, including the notes of WH, which assured compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder, and with the Rules of the NASD.

C-16. Nuveen made misleading statements of material fact, and omitted to make statements of material fact necessary to make the statements made not misleading in selling WH notes to members of the plaintiff class, in violation of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

(a) Nuveen did not advise the buyers of WH notes that WH notes were not prime commercial paper.

(b) Nuveen did not give financial information or other information concerning WH to the buyers of WH notes from Nuveen.

(c) Nuveen's salesmen, Feigelson, represented to plaintiff that Nuveen was the "Cadillac of the industry," and that WH notes were of the "highest quality".

(d) Nuveen sold WH notes on the basis that there would be no question but that the notes would be paid when due.

(e) Nuveen made and disseminated to buyers of WH notes from Nuveen false and misleading reports on WH which stated that the financial information contained in those reports was prepared from a detailed audit of WH.

(f) Nuveen failed to furnish to the purchasers of WH notes, at or before delivery of said notes by Nuveen, information relating to the ability of WH to pay its notes at maturity.

(g) Nuveen failed to make a reasonable investigation of the trust of the statements made by WH concerning its financial condition.

(h) Nuveen did not have reasonable ground for a belief that the WH notes Nuveen sold would be paid when due.

(i) Nuveen did not adopt written procedures for the purchase and sale of commercial paper, including WH notes, to assure compliance by its personnel with applicable securities laws, rules and regulations and statements of policy promulgated thereunder and with the Rules of the NASD. *S.E.C.* v. *First Securities, supra; Buttrey* v. *Merrill Lynch,* 410 F.2d 135 (7th Cir. 1969), cert. denied 396 U.S. 838 (1969).

C-17. In those instances in which purchasers of WH notes from Nuveen relied on the sole discretion of Nuveen for selection of the commercial paper to be purchased, Nuveen violated the securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by failing to make a reasonable investigation of WH and to form well-grounded belief that such notes would be paid upon maturity. *Tcherepnin* v. *Knight,* 389 U.S. 332, 88 S.Ct. 548 (1967).

C-18. IDS, Investors Syndicate of America, Inc. and Alleghany Corporation are liable as controlling persons of Nuveen to the members of the plaintiff class who purchased WH notes from Nuveen after September 15, 1969 for the violation of the Securities Act and the Securities Exchange Act perpetrated by Nuveen in the sale of WH notes. *S.E.C.* v. *First Securities Company of Chicago,* 463 F.2d 981 (7th Cir. 1972).

C-19. Nuveen is liable to the plaintiff class for the balance due or loss incurred on any WH note held by them and purchased from Nuveen, and for interest on said balance due or loss incurred at the rate of interest said buyer would have received if the note had been paid at maturity, and IDS, Investors Syndicate of America, Inc., and Alleghany are liable, jointly and severally with Nuveen for such amounts due on WH notes sold by Nuveen after September 15, 1969. *Swanson* v. *American Consumer Industries, Inc.,* 475 F.2d 516 (7th Cir. 1973). *S.E.C.* v. *Texas Gulf Sulphur,* 312 F.Supp. 77, 93 (S.D.N.Y. 1970), *Norte* v. *Huffines,* 288 F.Supp. 644 (E.D.N.Y. 1971), *Gerstle* v. *Gamble-Skogmo,* 332 F.Supp. 644 (E.D.N.Y. 1971), *S.E.C.* v. *First Securities Company of Chicago, supra.*

Judgment

The Court having entered herein simultaneously herewith its findings of fact and conclusions of law does hereby consider, order and adjudge as follows:

1. The term "WH noteholders" shall mean those persons and firms who purchased or who hold notes issued by WH which were sold by Nuveen and which notes have not been paid in full, or in the sale of which a loss was incurred by the purchaser from Nuveen, except that a WH noteholder who has opted out of this action shall not be deemed a WH noteholder hereunder.

2. Nuveen shall offer to pay to each WH noteholder, except Chicago Title and Trust Company as Trustee of the Winter and Hirsch Inc. Liquidating Trust, and except any WH noteholder who has opted out of the action, the amount remaining unpaid on the WH note held or the loss incurred by the WH noteholder in the sale of any such note, together with interest from the maturity date of such note to the date judgment is entered herein, at the rate of interest which said noteholder would have received had his note been paid at maturity, and IDS, Investors Syndicate of America, Inc. and Alleghany Corporation shall offer to pay, jointly and severally with Nuveen all such amounts for WH notes sold by Nuveen after September 15, 1969.

3. Any WH noteholder accepting the offer set forth in paragraph 2 above, who still holds a note issued by WH shall be required to surrender to the defendant or defendants making payment to such noteholders in accordance with this Judgment Order the WH note held by him properly endorsed to said defendant or defendants.

4. Any WH noteholder who has consented to the WH Liquidating Trust and has delivered his WH note to the Trustee of the WH Liquidating Trust, shall be required to execute and deliver to the defendant or defendants making payment to such noteholder in accordance with this Judgment Order, an assignment of all his interest in and to the WH Liquidating Trust which arises from or is based upon

the surrender of said WH note to the Trustee of said Liquidating Trust.

5. Defendants shall supply to the Clerk of this Court a list of all the WH noteholders with the last known address of such noteholder listed, together with properly stamped envelope addressed to each noteholder, and the Clerk of the Court is hereby directed to enclose in each such stamped, addressed envelope a notice of the offer to be made by defendants hereunder, said notice to be in the form annexed hereto as Exhibit A. All costs of mailing and duplicating the Notice are to be paid by defendants.

6. Acceptance of the offer to be made by defendants hereunder must be submitted to and received by the Clerk of the Court not later than thirty (30) days from the date of mailing of such Notice accompanied by a claim form executed by the WH noteholder, or the successor in interest thereto through the laws of succession or devise, substantially in the form of Exhibits 1, 2 or 3 annexed hereto and to Exhibit A.

7. Counsel for the parties shall be permitted to examine the claims submitted to the Clerk of the Court, and within forty-five (45) days after the date of the mailing of the Notice any party may file written objections to any claim submitted specifying the basis for said objections. Said objections, if any, shall be disposed of as the Court may thereafter order.

8. Within thirty days after objections to claims filed hereunder are heard, or within sixty days after the date of the mailing of the Notice to the WH noteholders, if no objections are filed, defendants shall prepare and deliver to the Clerk of this Court checks in exchange for the WH notes and assignments of interest in the WH Liquidating Trust submitted pursuant to this Judgment Order, payable to

the payees appropriate in each instance, which checks shall promptly be mailed by the Clerk of this Court to each of said payees, at the last known address indicated by them upon their acceptance. All costs of disbursement of said sums shall be paid by defendants.

9. It Is Further Ordered that Plaintiff shall recover the costs of suits. This Court retains jurisdiction of this action to correct, modify, annul, vacate and supplement the foregoing Judgment Order, and to hear the Petition of Plaintiffs' attorneys for fees and reimbursement of expenses, and to make an award thereon.

Dated at Chicago, Illinois this 15th day of October, 1974.

/s/ J. S. PERRY

[EXHIBITS OMITTED]

IN THE UNITED STATES COURT OF APPEALS
for the Seventh Circuit

September Term, 1971—January Session, 1972

Nos. 71-1163, 71-1164
HENRY T. SANDERS,
Plaintiff-Appellant,
v.
JOHN NUVEEN & CO., INC.,
Defendants-Appellees.

HENRY T. SANDERS,
Plaintiff-Appellee,
v.
JOHN NUVEEN & CO., INC.,
Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 70 C 597

J. SAM PERRY, Judge.

Argued January 26, 1972—Decided June 9, 1972

Before HASTINGS, *Senior Circuit Judge,* and KILEY and SPRECHER, *Circuit Judges.*

SPRECHER, *Circuit Judge.* This appeal raises two principal issues: (1) whether promissory notes with a maturity not exceeding nine months but offered to the public as an investment are "securities" within the definition of the Securities Exchange Act of 1934 and (2) whether the representative of an antagonistic class can properly intervene and assume representation of the plaintiff class without notice to the members of that class?

Plaintiff, Henry T. Sanders, filed his complaint on March 12, 1970, against John Nuveen & Co., Inc., a broker-dealer in securities, one of its registered representatives, and its directors and controlling persons. The complaint charged

defendants with a scheme and artifice to defraud plaintiff and others in his class by selling to them short-term commercial paper issued by Winter & Hirsch, Inc. but owned by Nuveen. Plaintiff's claim was based on the Securities Act of 1933, 15 U. S. C. § 77a, the Securities Exchange Act of 1934, 15 U. S. C. § 78a, Rule 10b-5, 17 C. F. R. § 240.10b-5, and the Rules of Fair Practice of the National Association of Securities Dealers.

On May 18, 1970, the defendants moved to strike certain allegations of the complaint and expressly attacked the class-action aspects of the complaint. They also challenged the jurisdiction of the court under the 1934 act on the ground that the short-term commercial paper involved was not a "security." The district court denied the motion to strike on October 8, 1970.

On October 19, 1970, the plaintiff served on defendants his motion, to be presented to the court on November 2, requesting that a notice be sent to the class represented by plaintiff as provided in Rule 23(c)(2) of the Federal Rules of Civil Procedure. The class suggested was "all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch, Incorporated, and sold by John Nuveen & Co., Inc."

On October 29, the First National Bank of Chicago and the Harris Trust and Savings Bank sought leave to intervene on their own behalf and "on behalf of certain creditors of Winter & Hirsch, Incorporated."

The motion to intervene stated that on March 11, 1970 (one day prior to the filing of plaintiff's suit), the creditors of Winter & Hirsch had met and had elected an informal creditors' committee. The creditors' committee, working with the management of Winter & Hirsch, had negotiated with Mercantile Financial Corp. a purchase agreement

relating to substantially all of Winter & Hirsch's loan receivables; the agreement required certain waivers by holders of long-term debt obligations. The motion also stated that the creditors' committee had developed a liquidating trust to become effective upon the execution and delivery of a "Consent and Agreement" by all the lenders of funds to Winter & Hirsch, including plaintiff.

At the same time that they sought to intervene, the two banks also moved that the district court enter an order pursuant to Rule 23(d) directing the plaintiff to execute a "Consent and Agreement" on a stipulation by all parties that its execution would "not constitute a dismissal or compromise under Federal Rule 23(e)."

The banks' motions were not accompanied by any pleadings in the Rule 7(a) sense of complaints or answers, or by documents seeking to adopt pleadings already on file.

Plaintiff's counsel were notified by telephone the night before that the banks were going to appear before the district judge on October 29; counsel were given copies of the motions at 10 a.m. on the 29th as court convened. The court continued the matter to 1:45 p.m., at which time the plaintiff filed written objections to the motions. The court heard argument by the parties but no evidence in the afternoon, at which time the court requested the parties to attempt to agree on an order. The banks delivered a proposed form of order to plaintiff's counsel at 4 p.m. and advised them that they would reappear in court at 4:30. Plaintiff's counsel replied that they would need some time to read the proposed order and confer with their client. They appeared at the courtroom at 4:50 to learn that the judge had entered an order at 4:35 and left the bench. The order permitted the banks to intervene and directed the plaintiff to sign the stipulation and consent by 5 p.m. or the class aspects of the complaint would be stricken. The intervention was allowed

on behalf of creditors including all members of the class which plaintiff sought to represent.

The plaintiff filed a motion to vacate the October 29 order, which motion was denied on November 5, 1970. The court's reason was "the plaintiff's expressed opposition to all members of the class by refusing to join in a compromise that all of them have agreed to enter into." On its own motion, the court found that "there may be a class described in the cause without counsel," whereby he ordered that "said cause . . . proceed as an individual complaint."

On November 17, 1970, the district judge certified pursuant to 28 U. S. C. § 1292(b) the questions (1) whether it was error to permit the banks to intervene, (2) whether it was error to find that the plaintiff did not represent the class and (3) whether it was error to strike the class aspects of the complaint. On the motion of defendants, the court on the following day amended its prior order denying defendants' motion to strike, to certify another question under 28 U. S. C. § 1292(b): whether the commercial paper upon which the complaint is predicated is a "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934.

This court granted leave to appeal on all four questions on December 21, 1970.

We consider first the threshold question of whether a security under the 1934 act is involved.

I

Federal securities legislation enacted for the purpose of avoiding frauds is to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *S. E. C.* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963).

Particularly, the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293, 299 (1946). "[I]n searching for the meaning and scope of the word 'security' in the [Securities Exchange] Act [of 1934], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin* v. *Knight*, 389 U. S. 332, 336 (1967).

The Supreme Court has sanctioned, in interpreting the definition of a security in the 1934 act, recourse to the definitions of security in the Securities Act of 1933 (*Tcherepnin* at 335-36, 338) and in the "companion legislative enactments." *Affiliated Ute Citizens* v. *United States*, 40 U. S. L. W. 4448, 4455 (1972).

An examination of the six basic federal securities acts is relevant and revealing.

The Securities Act of 1933,[1] the Trust Indenture Act of 1939,[2] the Investment Company Act of 1940,[3] and the Investment Advisers Act of 1940,[4] all define a security as follows: "The term 'security' means any note, . . . evidence of indebtedness, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security'. . . ."[5] The Public Utility Holding Company Act of 1935[6] definition differs slightly: "'Security' means any

[1] Section 2(1). 15 U. S. C. § 77b(1).

[2] Section 303(1). 15 U. S. C. § 77ccc(1).

[3] Section 2(a)(36). 15 U. S. C. § 80a-2(a)(36).

[4] Section 202(a)(18). 15 U. S. C. § 80b-2(a)(18).

[5] Mr. Justice Blackman, in commenting upon the language of Rule 10b-5 said that proscriptions of the securities laws, by "repeated use of the word 'any' are obviously meant to be inclusive." *Affiliated Ute Citizens* v. *United States*, 40 U. S. L. W. 4448, 4455 (1972).

[6] Section 2(a)(16). 15 U. S. C. § 79b(a)(16).

note, . . . investment contract, . . . or, in general, any instrument commonly known as a 'security'. . . ."[7]

In none of these five acts does there appear any language limiting in any way the broad definitions of "security" or of "note," "evidence of indebtedness," "investment contract" or "instrument commonly known as a security." Therefore *any* note, regardless of its nature, terms or conditions, is fully subject to whatever antifraud provisions are included in the five acts.

Only in the Securities Exchange Act of 1934 is there an exception to the broad definition of a security; it reads:[8]

> "The term 'security' means any note, . . . investment contract, . . . or in general, any instrument commonly known as a 'security'; . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Therefore only in the 1934 act is a note with a maturity not exceeding nine months withdrawn from the application of the antifraud provisions of the act, section 10(b) and Rule 10b-5. Since the same note is subject to the antifraud provisions of all the other securities acts, it becomes important to determine just what Congress intended to be exempt from the operation of the 1934 act.

Although all notes are subject to the antifraud provisions of the other acts, some of those acts exempt short-term commercial paper from registration or other requirements.[9]

[7] In *Tcherepnin* v. *Knight*, 389 U. S. 332, 344 (1967), the Supreme Court found no "controlling significance" in the fact that the term "evidence of indebtedness," which was included in the 1933 act, was omitted from the 1934 act.

[8] Section 3(a)(10). 15 U. S. C. § 78c(a)(10).

[9] *Tcherepnin* v. *Knight*, 389 U. S. 332 (1967) (withdrawable capital shares of savings and loan association subject to Rule 10b-5 although exempt from registration). *See also* Opinion of Director of Trading & Exchange Division of S. E. C., Release No. IA-40, 11 F. R. 10997 (1945).

Plaintiff urges that the meaning given to short-term obligations in other securities legislation, particularly the 1933 act, be applied to the definition found in the 1934 act. The 1933 act exempts from registration,[10] but not from antifraud sanctions,[11] "[a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions," and which has a maturity not exceeding nine months.

The Securities and Exchange Commission has interpreted the 1933 act's exemption of short-term commercial paper as embodying four requirements:[12]

> "The legislative history of the Act makes clear that section 3(a)(3) applies only to (1) prime quality negotiable commercial paper (2) of a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks."

Although no evidence has been heard in this case, the record shows that the commercial paper purchased by the plaintiff was dated January 30, 1970, and that "Winter & Hirsch was engaged in the business of making loans until in or about February 1970, when it advised its creditors of its precarious financial condition and ceased to make any

[10] Section 3(a)(3). 15 U. S. C. § 77c(a)(3).

[11] Section 17(c). 15 U. S. C. § 77q(c).

[12] Release No. 33-4412, 17 C. F. R. § 231.4412 (1961) (numerals added). The release emphasized the prime quality of the paper intended to be exempted and stated that the exempted items are "composed of assets easily convertible into cash and are comparable to liquid inventories of an industrial or mercantile company." During the hearings on the 1933 act, commercial paper discountable by Federal Reserve banks was described as having "a record of safety only second to Government bonds" and as being the basis of our currency. Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73rd Cong., 1st Sess. at 94, 95 (1933). It is significant that section 3(a)(10) of the 1934 act exempts "currency" from the definition of security. 15 U. S. C. § 78c(a)(10).

further payments on any of its obligations for borrowed money." At that time it had assets of $12.5 million and liabilities of more than $36 million. Thus, because of the company's insolvency, it seems highly unlikely that the paper purchased by the plaintiff and members of his class is either prime quality or issued to facilitate current transactions or eligible for discounting by Federal Reserve banks.

The record further shows that the commercial paper purchased by the plaintiff was "placed through John Nuveen & Co."[12] and bought by 42 purchasers, including the plaintiff, in the aggregate face amount of $1,661,500. The paper was therefore obviously offered and sold to the general public; indeed, it was characterized in the issuer's financial statements as "short term open market" paper.[13] The notes fail to meet any of the S. E. C.'s four requirements for exemption.

If, as the Supreme Court has admonished, "form should be disregarded for substance" and economic reality emphasized, it is reasonably clear that plaintiff and his class purchased the kind of "security" in regard to which the securities acts were intended to offer protection against fraud, misrepresentation and non-disclosure.[14] Five of those acts expressly did so. We believe Congress intended to protect against fraud the purchasers of securities such as those involved here under the 1934 act as well.[15]

[13] H. R. Rep. No. 85, 73rd Cong., 1st Sess., 15 (1933) stated in discussing the bill, which became the Securities Act of 1933, "Paragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors."

[14] Forty of the purchasers invested from $3,000 to $100,000 and the other two invested $150,000 and $205,000. In *Tcherepnin*, the Supreme Court, noting that small investors were involved, said (389 U. S. at 345): "Policy considerations lead us to conclude that these petitioners are entitled to the investor protections afforded by the Securities Exchange Act."

[15] Professor Loss equates the 1933 act meaning of security with that of the 1934 act to some extent: "Short-term notes of the type which are *exempted from registration* under the Securities Act by § 3(a)(3) are *excluded from the definition of 'security'* in the Exchange Act." 2 Loss, Securities Regulation 796 (1961).

The court in *Anderson* v. *Francis I. duPont & Co.*, 291 F.Supp. 705, 708-09 (D. Minn. 1968), reached the same conclusion. Promissory notes of less than nine months' maturity were given in exchange for investments in defendant's commodities market scheme. The court held the 1934 act applicable to the notes.

Our conclusion is further supported by Congress' characterization of short-term commercial paper in exempting it from certain provisions (but not antifraud provisions) of two of the other securities acts. Certain provisions of the Public Utility Holding Company Act of 1935 do not apply to a note or draft with a maturity not exceeding nine months, provided that it "is not part of a public offering" and aggregates not more than 5 percent of the other securities of the company.[16] The Investment Company Act of 1940 defines "short-term paper" as paper with a maturity not exceeding nine months "and such other classes of *securities, of a commercial rather than investment character*, as the Commission may designate by rules and regulations."[17]

In other words, when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities.[18] When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to invest his money and receives a note in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment. *Cf. City National Bank* v. *Vanderboom*, 290 F.Supp. 592, 608 (W. D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U. S. 905 (1970).

[16] Section 6(b). 15 U. S. C. § 79f(b).

[17] Section 2(a)(38). 15 U. S. C. § 80a-2(a)(38) (emphasis added).

[18] Although some of the paper placed through Nuveen went to banks, the large majority of purchasers were individuals.

Although further evidence may be necessary to determine the issue, the allegations of the complaint together with additional information in the record on appeal indicate a strong possibility that Nuveen's arrangements with the plaintiff and with the members of plaintiff's class also constitute investment contracts. Apparently, Nuveen purchased the Winter & Hirsch paper at a discount and resold it to the 42 purchasers at a different rate of discount in order to realize a profit. At least in the plaintiff's case (and evidence would be necessary to determine in how many other cases), the use of plaintiff's funds for the short-term notes was a temporary arrangement "in lieu of tax exempt municipal bonds and . . . the money so invested would be available for purchase of tax exempt bonds at an early date."

It seems likely that the arrangements between Nuveen and plaintiff constituted "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293, 298 (1946). *See also* 1 Loss, Securities Regulation 489-91 (1961); *Anderson* v. *Francis I. duPont & Co.*, 291 F.Supp. 705, 708 (D. Minn. 1968).[19]

However, in view of our interpretation that the instruments involved here are securities since they are notes not covered by the exemption, we do not need to determine whether as a matter of fact the arrangements between the parties also constituted investment contracts.

[19] Professor Bromberg has noted, "Even if short term notes are effectively excluded from the definition of security, their use in connection with an investment contract or other transaction constituting a security does not immunize the transaction from the antifraud rules." Bromberg, *Securities Law, Fraud, SEC Rule 10b-5*, § 4.6(321) (1971).

II.

The remaining three issues certified for determination can be considered together: whether the allowance of the bank's intervention was proper and whether the district court erred in finding that the plaintiff did not represent the class and in striking the class allegations from the complaint.

The record discloses that the two intervening banks are holders of "short term senior debt" as banks extending lines of credit, First National Bank of Chicago in the amount of $1,750,000 and Harris Trust and Savings Bank in the amount of $1,000,000. As such, neither bank would come within the class suggested by the plaintiff, namely, all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch and sold by John Nuveen & Co. The plaintiff has alleged in addition, and the banks have not denied, that each bank is also the holder or owner of substantial amounts of long-term debt of Winter & Hirsch, which is described in the liquidating trust agreement as "junior subordinated debt."

Since it is acknowledged by all parties that Winter & Hirsch is insolvent and unable to pay its debts as they mature, it is reasonably certain that the creditors will eventually receive less than the amounts which they are owed. It follows that any advantage obtained by one class of creditors will cause other classes of creditors to be disadvantaged. The two intervening banks, as members of at least two classes of creditors other than the class represented by the plaintiff, are *per se* antagonistic to the plaintiff's class. It is obvious that the banks can neither represent the plaintiff's class nor strengthen the representation of plaintiff's class by intervening.

The portions of Rule 23(d) pertaining to intervention in class actions are intended to strengthen the adequacy

of representation of the class.[20] The Advisory Committee's Note to Rule 23 emphasizes, "Subdivision (d) is concerned with the fair and efficient conduct of the action" through supplementary notice to members of the class and by strengthening the class where necessary.[21]

Since the district judge did not provide for any notice to the plaintiff class, it was clearly improper for him to permit the two banks, with their conflicting and antagonistic interests, "to intervene herein, on their own behalf and on behalf of those creditors of Winter & Hirsch, Incorporated set forth in Exhibit B to the Motion to Intervene." That exhibit listed among others, the members of plaintiff's suggested class: all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch and sold by Nuveen. The effect of such intervention was to weaken the plaintiff class and possibly to strip from its advantages which it held against other classes of creditors, including the classes of which the two intervening banks are members. The attempt to include some protective language in the intervention order purported to represent the class, the plaintiff's cause virtually collapsed. No intervention could be accomplished without prior full and fair notice to the members of

[20] Fed. R. Civ. P. 23(d): "In the conduct of actions to which this rule applies, the court may make appropriate orders: . . . (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors. . . ."

[21] Advisory Committee Note to Rule 23 states in part: "Subdivision (d)(2) sets out a non-exhaustive list of possible occasions for orders requiring notice to the class. . . . [The] mandatory notice pursuant to subdivision (c)(2), together with any discretionary notice which the court may find it advisable to give under subdivision (d)(2), is designed to fulfill requirements of due process to which the class action procedure is of course subject. . . . Subdivision (d)(3) reflects the possibility of conditioning the maintenance of a class action, *e.g.*, on the strengthening of the representation . . . ; and recognizes that the imposition of conditions on intervenors may be required for the proper and efficient conduct of the action."

plaintiff's class and, of course, such notice could not be given until the court determined whether plaintiff's suggested class fulfilled the requirements of Rule 23(a) and (b)(3).[22]

If in fact the bank had procured the "consent and agreement" of all the members of plaintiff's class other than plaintiff, such consent and agreement was meaningless within the context of this cause of action unless procured after full and fair notice and disclosure to the members of the class, under the supervision of the court, of their possible rights in this cause, of the conflicting interests of other classes of creditors, including the banks, and of the surrender of certain rights by consenting and agreeing to the liquidating trust arrangement. The purpose of the mandatory notice and disclosure requirements of Rule 23(c)(2) is to advise all class members of their rights and privileges under the close supervision of the court.

This is not to say that the banks could not intervene under any circumstances. Once the court has determined whether the plaintiff's suggested class satisfies the requirements of Rule 23(a) and (b)(3), and once members are notified under Rule 23(c)(2), the banks may seek to intervene under Rule 24(a)(2). They would petition not as representatives of the plaintiff's class, but as applicants who claim "an interest relating to the property or transaction which is the subject of the action and [are] so situated that the disposition of the action may as a practical matter impair or impede [their] ability to protect that interest. . . ." At that point, the court may determine that the members of plaintiff's class are entitled to supplementary notice under Rule 23(d)(2).[23]

[22] *Hohmann* v. *Packard Instrument Co.*, 399 F.2d 711 (7th Cir. 1968).

[23] In order to expedite the proceedings, the court may determine that it is feasible to combine the mandatory notice under Rule 23(c)(2) with the discretionary notice under 23(d)(2).

If the banks seek to intervene under those circumstances, Rule 24(c) and sound judicial administration require that their motion to intervene "shall state the grounds therefor and shall be accompanied by a pleading setting forth the claim or defense for which intervention is sought." The pleading should be one of those described in Fed. R. Civ. P. 7(a) so that all parties understand the position, claims and nature of relief sought by the prospective intervenors.

Once the due process requirements of Rule 23 are satisfied by full and fair notice to all members of any class or classes or subclass or subclasses determined by the court, the court may then "make appropriate orders . . . determining the course of proceedings."[24]

The basic error in these proceedings was permitting two members of antagonistic classes to intervene on behalf of another (plaintiff's) class and not only to purport to take over plaintiff's case but in effect to introduce an entirely different cause of action in which all parties but plaintiff had previously "consented" without notice and disclosure under court supervision of their rights and options. The error was compounded by attempting to coerce the plaintiff to add his consent.

In No. 71-1163 we reverse the orders which allow intervention, which find the plaintiff not representative of the class alleged in the complaint and which strike allegations in the complaint as to class action. In No. 71-1164, we affirm the order denying the motion to strike certain allegations of the complaint, because the commercial paper on which the plaintiff predicated his claim for relief is a "security" under the Securities Exchange Act of 1934. The case is remanded for further proceedings consistent with this opinion.

[24] Fed. R. Civ. P. 23(d)(1). It should also be noted that not only may a class be divided into subclasses if that course seems advisable to the trial court (Rule 23(c)(4)), but also that any order fixing classes or subclasses "may be conditional, and may be altered or amended before the decision on the merits" (Rule 23(c)(1)).

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 9, 1972

Before

Hon. JOHN S. HASTINGS, *Senior Circuit Judge*
Hon. ROGER J. KILEY, *Circuit Judge*
Hon. ROBERT A. SPRECHER, *Circuit Judge*

No. 71-1163, 71-1164
HENRY T. SANDERS,
Plaintiff-Appellant,
vs.
JOHN NUVEEN & Co., INC.,
Defendants-Appellees.

HENRY T. SANDERS,
Plaintiff-Appellee,
vs.
JOHN NUVEEN & Co., INC., ET AL.,
Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois Eastern Division.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that orders of the United States Court for the Northern District of Illinois, Eastern Division, which allow intervention, which find the plaintiff not representative of the class alleged in the complaint and which strike allegations in the complaint as to class action, being the

judgments appealed from in appeal number 71-1163, Henry T. Sanders, Plaintiff-Appellant v. John Nuveen & Co., Inc., Defendants-Appellees, be and the same are hereby Reversed.

IT IS FURTHER ORDERED AND ADJUDGED BY THIS Court that in appeal number 71-1164, Henry T. Sanders, Plaintiff-Appellee v. John Nuveen & Co., Inc., Defendants-Appellants, the judgment of the said District Court denying the motion to strike certain allegations of the complaint, be and the same is hereby Affirmed.

IT IS FURTHER ORDERED that this case be and the same is hereby Remanded to the said District Court for further proceedings consistent with the opinion of this Court filed this day.

IT IS FURTHER ORDERED and adjudged by this Court that the costs in both appeals be taxed in favor of Plaintiff Henry T. Sanders and against Defendants John Nuveen & Co., Inc., et al.

IN THE UNITED STATES DISTRICT COURT

For the Northern District of Illinois

Eastern Division.

HENRY T. SANDERS,
Plaintiff,
vs.
JOHN NUVEEN & Co., INC., et al.,
Defendants.

No. 70 C 597

AMENDED ORDER

The Court has examined and considered the Motion to Strike Certain Allegations of the Complaint filed by defendants wherein and whereby they request that the class allegations of the Complaint be stricken; that all claims under the Securities Exchange Act of 1934, which are those alleging violations of Section 10(b) [15 U. S. C. 77j(b)] and 20 [15 U. S. C. 78t] of that Act and Rule 10b-5 [17 C. F. R. 240. 10b-5] thereunder and those based on violations of NASD Rules of Fair Practice should be stricken; and that all claims under Section 17 of the Securities Act of 1933 should be stricken; and the Court has also examined and considered Memorandum in Support of Certain Defendants' Motion to Strike Certain Allegations of the Complaint; Plaintiff's Memorandum in Opposition to Defendants' Motion to Strike Certain Allegations of the Complaint; and the Defendants' Reply Memorandum in Support of Motion to Strike Certain Allegations of the Complaint, and the Court is of the opinion that said Motion to Strike Certain Allegations of the Complaint filed by the defendants is not well taken and should be denied, and that said defendants should file their Answer to said Complaint within a short day.

Therefore, it is ordered that the Motion to Strike Certain Allegations of the Complaint filed by the defendants be and the same is hereby denied.

Paragraph 2 of defendants' motion asked that all claims in the complaint predicated on the Securities Exchange Act of 1934 be dismissed. These allegations pertain to Section 10(b) of the Act, Rule 10b-5 issued by the Securities and Exchange Commission and to the rules of the National Association of Securities Dealers. Defendants assert that the commercial paper purchased by plaintiff and on which he predicates his claim for relief is not a security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. With respect to the issues raised by Paragraph 2 of defendants' motion, the Court is of the opinion that this order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation.

Dated: November 18, 1970.

ENTER:

/s/ J. S. PERRY,
Judge.

IN THE UNITED STATES DISTRICT COURT

For the Northern District of Illinois

Eastern Division.

HENRY T. SANDERS,
Plaintiff,
vs.
JOHN NUVEEN & Co., INC., et al.,
Defendants.

No. 70 C 597

ORDER

The Court has examined and considered the Motion to Strike Certain Allegations of the Complaint filed by Defendants wherein and whereby they request that the class allegations of the complaint be stricken; that all claims under the Securities Exchange Act of 1934, which are those alleging violations of Section 10(b) (15 U. S. C. 77j(b)) and 20 (15 U. S. C. 78t) of that Act and Rule 10b-5 (17 C. F. R. 240, 10b-5) thereunder, and those based on violations of NASD Rules of Fair Practice should be stricken; and that all claims under Section 17 of the Securities Act of 1933 should be stricken; and the Court has also examined and considered Memorandum in Support of Certain Defendants' Motion to Strike Certain Allegations of the Complaint; Plaintiff's Memorandum in Opposition to Defendants' Motion to Strike Certain Allegations of the Complaint; and the Defendants' Reply Memorandum in Support of Motion to Strike Certain Allegations of the Complaint, and the Court is of the opinion that said Motion to Strike Certain Allegations of the Complaint filed by the Defendants is not well taken and should be denied, and that said Defendants should file their answer to said complaint within a short day.

Therefore, it is Ordered that the Motion to Strike Certain Allegations of the Complaint filed by the Defendants be

and the same is hereby denied, and said Defendants be and they are hereby directed to file their answer to said complaint within 20 days from the date of this order.

Case called for status 9:30 November 20, 1970.

Dated: October 8, 1970.

/s/ J. S. PERRY,
Judge.

Part B. Statutes and Rule

SECURITIES ACT OF 1933.

SECTION 2. DEFINITIONS.

When used in this title, unless the contest otherwise requires—

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

SECTION 3. EXEMPTED SECURITIES.

(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

(3) Any note, draft, bill of exchange, or bankers' acceptance, which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance or not exceeding nine months, exclusive of days of grace or any renewal thereof, the maturity of which is likewise limited.

Section 11. Civil Liabilities on Account of False Registration Statement.

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning

statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable

investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert: and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or

that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided*, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value

of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

SECTION 12. CIVIL LIABILITIES ARISING IN CONNECTION WITH PROSPECTUSES AND COMMUNICATIONS.

Any person who—

(1) offers or sells a security in violation of section 5 of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission

shall be liable to the person purchasing such security from him, who, may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

SECURITIES EXCHANGE ACT OF 1934.

SECTION 3. DEFINITIONS AND APPLICATION.

(a) When used in this title, unless the context otherwise requires—

* * * * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

SECTION 10. MANIPULATIVE AND DECEPTIVE DEVICES.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • • • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

General Rules and Regulations of the Securities and Exchange Commission Under the Securities Exchange Act of 1934.

RULE 10b-5. EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase of sale of any security.

Supreme Court U. S.
FILED
FEB 26 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-1065

JOHN NUVEEN & CO., INC., A CORPORATION, INVESTORS SYNDICATE OF AMERICA, INC., A CORPORATION, AND INVESTORS DIVERSIFIED SERVICES, INC., A CORPORATION,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

RICHARD ORLIKOFF,
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Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-1065.

JOHN NUVEEN & CO., INC., A CORPORATION, INVESTORS SYNDICATE OF AMERICA, INC., A CORPORATION, AND INVESTORS DIVERSIFIED SERVICES, INC., A CORPORATION,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

Respondent respectfully submits that the Petition for a Writ of Certiorari should be denied since the decision below does not conflict with decisions of this Court, there is no conflict of decisions among the Circuit Courts of Appeals on any issue decided by the Court below, and the decision below is correct.

OPINIONS BELOW.

The opinions and orders below are described in the Petition, and are reprinted in the Appendix to the Petition.

JURISDICTION.

The jurisdictional requisites are adequately set forth in the Petition.

QUESTIONS PRESENTED.

1. Are non-prime, short-term notes sold in small denominations to the public for investment purposes subject to the provisions of the Securities Exchange Act of 1934?

2. Is an underwriter and exclusive seller of non-prime, short-term notes sold to the public in small denominations and subsequently dishonored liable to purchasers to whom the underwriter sold the notes for failure to make a reasonable investigation of the issuer?

3. May an underwriter of the sale of securities subject to the Federal Securities Acts reasonably and properly rely upon financial statements of the issuer made by auditors whom the underwriter does not know, has never met, and does not meet, and where the underwriter has not examined any corporate records, contracts or income tax returns of the issuer?

4. May an underwriter reasonably and properly rely on financial statements of an issuer of securities when the auditor expressly states that its opinion is based upon comments which show serious deficiencies in the auditor's examination of the issuer?

5. Is an underwriter-dealer in short-term notes liable under § 12(2) of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder to its purchasers for failing to state to the purchasers that the notes bear an inferior credit rating and for making misrepresentations of material facts concerning the notes?

STATUTES AND RULES INVOLVED.

The statutes and rules involved are set forth in the Petition, p. 3, and in the Appendix to the Petition, A. 69-77, with the exception of Rule 27 of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., which is set forth in the Appendix hereto, A1.

STATEMENT OF THE CASE.

The facts in this case are set forth at length in the Findings of Fact entered by the District Court. A. 20-40. Among the salient facts not appearing in the Petition are the following.

Prior to acquisition of Ashwell & Company in September, 1968, John Nuveen & Co., Inc. ("Nuveen") had never sold short-term notes. From September 1, 1968 to February 10, 1970, Nuveen was the exclusive seller of notes issued by Winter & Hirsch, Inc. ("WH"). From January 1, 1969 to the time Nuveen ceased to sell WH notes it made approximately 275 sales of such securities with a face value of $9,305,500.

Nuveen made no examination or credit investigation of any issuer prior to the time Nuveen commenced to sell the notes of that issuer. None of the notes sold by Nuveen was rated "Prime" by the National Credit Office ("NCO"). Nuveen had no requirement that the financial statements of companies whose notes it sold must be certified by a certified public accountant. Nuveen's personnel checked the credit of issuers of notes by analyzing the financial statements sent to them by the issuers, by reading NCO reports and by addressing credit inquiries to banks. The replies from banks neither showed the financial strength of an issuer, nor constituted a credit evaluation.

Nuveen never employed more than one credit investigator and for various periods had no credit investigator in its commercial paper department even though Nuveen sold notes issued by 40 to 50 different companies at any one time. At such times the head of the commercial paper department assumed credit checking duties. Nuveen's last commercial paper department head testified he was too busy to check credit.

One Nuveen credit investigator made on-site inspections of issuers. In March, 1969 he made a one-day visit to the offices of WH. He did not examine any internal control or accounting records, or corporate records. He testified he "most likely did"

examine WH's federal tax returns because it was his practice to do so. The 1968 WH federal tax return showed a loss of $955,000, while the 1968 audit report WH had sent to Nuveen showed a profit of $499,119.09 before provisions of $244,000 for income taxes for the year. The beginning balance sheet on the 1968 tax return did not agree with the ending balance sheet on the 1967 return.

Nuveen had no written policies or directives with reference to commercial paper.

In late December, 1969, the new head of Nuveen's commercial paper department had lunch with the President of WH, noted that he looked ill, and ordered Nuveen's credit investigator to do a credit report on WH. The investigator, who relied solely on WH's latest audit report, prepared a report in which WH notes were rated "Desirable" rather than "Prime", although Nuveen had no system for rating commercial paper. Ten days after that report the investigator sent credit inquiries on WH to a dozen banks. Nearly a month after the credit report an executive of one of the banks telephoned the head of Nuveen's commercial paper department and gave him information which led to the discovery by Nuveen that various banks had initiated an investigation of WH in December, 1969, and that an independent audit of WH had been commenced in early January, 1970. Nuveen then suspended the sale of WH notes.

REASONS FOR DENYING THE PETITION.

I. It Is Settled Law That Non-Prime, Short-Term Notes Sold To the Public for Investment Purposes Are Securities Subject to the Federal Securities Acts.

Petitioners are attempting to obtain review not only of the last decision in this case but also of an earlier decision that resulted from certification of a controlling question of law by the trial court.

In the earlier appeal it was held that the short-term notes issued by WH and sold by Nuveen were securities subject to the proscriptions of § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5, 17 CFR § 240. 10b-5. *Sanders* v. *John Nuveen & Co., Inc.*, 463 F. 2d 1075 (7th Cir. 1972), *cert. denied*, 409 U. S. 1009 (1972). (*Sanders I*, A. 49-62.) The question whether the notes here involved are securities as defined in § 3(a)(10) of the Securities Exchange Act of 1934, 15 U. S. C. § 78c(a)(10), was certified for immediate appeal by the District Judge under 28 U. S. C. § 1292 (b) as "a controlling question of law" in order to "materially advance the ultimate termination of the litigation." A. 66. The Court of Appeals accepted the interlocutory appeal and answered the certified question affirmatively. This Court denied certiorari and the case was remanded for trial. Voluminous discovery was taken and after a full trial the District Court found for respondent and the represented class. A. 20-48. On appeal the judgment entered by the District Court was affirmed. *Sanders* v. *John Nuveen & Co., Inc.*, 524 F. 2d 1054 (7th Cir. 1975). (*Sanders II*, A. 1-19.)

Although the Court of Appeals in *Sanders II* refused the request of petitioners to reconsider its holding in *Sanders I* (A. 6, n. 8), petitioners argue here that the Court of Appeals "reaffirmed its position after development of a complete record," and contend "the matter is now ripe for resolution by this Court."

Petition, p. 9, f.n. Should this Court grant certiorari and reverse *Sanders I* certification will have resulted in a large and wasteful expenditure of time and energy by the judiciary and the litigants.

Sanders I was correctly decided and has been widely followed. It is now settled law that the crucial distinction between notes subject to the anti-fraud provisions of the securities acts and those which are not is whether the transaction underlying the issuance of the note has a commercial character or whether the note was purchased for the purpose of investment. The date of maturity of the note is not meaningful to that distinction. While *Sanders I* was not the first decision to enunciate the investment/commercial dichotomy in determining whether notes are exempt securities,[1] *Sanders I* has become the wellspring of a fountain of decisions adopting and following that rationale. Expressly following *Sanders I* are *Zabriskie* v. *Lewis*, 507 F. 2d 546 (10th Cir. 1974); *SEC* v. *Continental Commodities Corp.* 497 F. 2d 516 (5th Cir. 1973); *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476, F. 2d 795 (2d Cir. 1973), *cert. denied*, 414 U. S. 908 (1973); and *The Franklin Savings Bank* v. *Levy*, CCH Sec. L. Rep. 95,389, at p. 78,961 *et seq.* (Current Binder) (S. D. N. Y. 12/29/75). See also *Smith* v. *Manausa*, 385 F. Supp. 443, 448 (E. D. Ky. 1974); and *Welch* v. *Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1396-8 (S. D. N. Y. 1974). In each of the foregoing cases the Court ruled that the notes involved were investment securities. In numerous decisions in which the Court ruled that notes were *not* investment securities and were exempt from the anti-fraud provisions of the 1934 Act, *Sanders I* is cited with approval, and the note involved is analyzed in accordance with the *Sanders I* rationale. See *C. N. S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F. 2d 1354,

1. See *Joseph* v. *Norman's Health Club*, 336 F. Supp. 307, 313 (E. D. Mo. 1971); *United States* v. *Hill*, 298 F. Supp. 1221, 1226-1227 (D. Conn. 1969); *Anderson* v. *Francis I. duPont & Co.*, 291 F. Supp. 705, 707-709 (D. Minn. 1968); *City National Bank of Fort Smith, Ark.* v. *Vanderboom*, 290 F. Supp. 592, 608 (W. D. Ark. 1968), *aff'd*, 422 F. 2d 221 (8th Cir. 1970), *cert. denied*, 399 U. S. 905 (1970).

1356 *et seq.* (7th Cir. 1975), *cert. denied* 96 S. Ct. 38 (1975); *Bellah* v. *First National Bank*, 495 F. 2d 1109, 1111 (5th Cir. 1974); *McClure* v. *First National Bank*, 497 F. 2d 490, 493 (5th Cir. 1974), *cert. denied*, 420 U. S. 930 (1975). See Lipton and Katz, "'Notes' Are Not Always Securities," 30 Bus. Lawyer 763 *et seq.* (April, 1975), in which numerous District Court decisions holding short-term notes to be either investment or commercial securities are discussed. In *Lino* v. *City Investing*, 487 F. 2d 689 (3d Cir. 1973), the court analyzed notes issued for the purpose of purchasing assets of a business as commercial notes, rather than investment securities, and thus exempt from the application of the federal securities acts.

The great majority of the decisions cited above, including *Sanders I*, rely in great part upon the opinions of this Court which call for a flexible and broad interpretation of the word "security", and emphasize that in this field form should be disregarded for substance and economic reality. *Tcherepnin* v. *Knight*, 389 U. S. 332 (1967); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180 (1963); *SEC* v. *W. J. Howey Co.*, 328 U. S. 293 (1946); *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943). This Court reaffirmed the principle of liberal and sensible interpretation of the term "security" in *United Housing Foundation, Inc.* v. *Forman*, ... U. S. ....., 95 S. Ct. 2051, 2058 *et seq.* (1975). In holding in *Forman* that shares of stock in a nonprofit housing cooperative were not "securities" within the purview of the 1933 and 1934 Acts, this Court cited *C. N. S.*, *McClure* and *Lino*, 95 S. Ct. at 2059, n. 13, in support of its determination that a literal approach to the definition of "security" was improper.

The enormous amount of commercial paper outstanding recounted by petitioners in their *ad terrorem* argument, Petition, 11, points up the need for protection of the investing public in the sale of "commercial paper". Stocks and bonds are also sold in great quantities. Nevertheless, both the securities industry and the economy have prospered even though the sale of such secur-

ities has been subject to the restrictions of the federal securities acts.

The decision petitioners here seek to review concerns only notes issued in relatively small denominations and sold to the public.[2] Presumably all such investment paper is now being registered with the SEC before being sold to the public, and the underwriters distributing and selling that paper are subject to the absolute liability provisions of the 1933 Act, as well as to the anti-fraud provisions of the 1933 and 1934 Acts.[3]

In the instant case it was clearly demonstrated in the record that the notes issued by WH and sold by Nuveen were sold to the public for investment purposes and were "securities" within the application of Rule 10b-5.

II. The Decision Below Properly Holds Petitioners Liable for Nuveen's Failure to Make a Reasonable Investigation of Winter & Hirsch, Inc.

While petitioners concede that Nuveen is an underwriter as defined in the 1933 Act (assuming WH notes are 'securities'), they nevertheless argue that Nuveen should not be held to the duties of an underwriter. Petition, 18, f.n. Petitioners and the

2. Thirty of the forty-three purchasers of notes dishonored by WH and sold by Nuveen were individuals. They purchased in denominations as low as $1,000.

3. The SEC has disapproved the sale of unregistered short-term notes to the public in denominations as high as a minimum of $10,000. Texas American Bancshares, Inc., letter available 9/3/74; Central Service Corp., 1973 CCH Sec. L. Dec. ¶ 79,460. Sale of short-term notes in lower minimum denominations without registration has been disapproved by the SEC. Real-Tex Enterprises, Inc., 1972-73 CCH Sec. L. Dec. ¶ 78,813; Neil Stephens Associates, Inc., letter available 1/9/74. Where notes in much larger denominations were advertised for sale to the public the SEC has disapproved sale without registration. American Automobile Insurance Brokers, Inc., letters available 7/19/74 and 6/24/74. The SEC has required a dealer in commercial paper to determine whether the security must be registered. *SEC* v. *Goldman, Sachs & Co.* (consent decree arising out of sale of Penn Central notes), CCH Fed. Sec. L. Rep. ¶ 94,556 (S. D. N. Y. 1974).

amici curiae do not object, however, to being held to the standards of a broker-dealer.[4]

Petitioners contend that because no registration statement was filed covering the sale of the notes here at issue § 11 of the 1933 Act is inapplicable. The standard of duty of an underwriter of securities is spelled out in § 11 of the 1933 Act, petitioners' argument continues, and therefore Nuveen cannot be held to that standard in an action brought under § 10(b) of the 1934 Act.

The objective of judicial decision-making in the securities field has been to effectuate the Congressional intent of protecting the investing public. *S. E. C.* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1973). In light of that objective it would be ironic if the underwriter could lessen his liabilities under the securities acts by avoiding the duties imposed by those acts. The decision of the Court below is based on testimony that Nuveen sold short-term notes on the basis "that there should be no question but what the paper will be paid at maturity." A. 2, 33. The sale of securities on that basis "enhanced the importance of determining the basic integrity of the issuer's financial statements." A. 9. The Court below properly implemented the statutory structure of the securities acts by holding that the distribution and sale of non-exempt securities by an underwriter who fails to make a reasonable investigation of the issuer is a "device, scheme or artifice to defraud," or an "act, practice or course of business which operates or would operate as a fraud or deceit upon any person . . ."[5] Rule 10b-5.

4. The *amici*, apparently feeling themselves free of the positions taken below by the parties, argue that the Court below erroneously characterized Nuveen as an underwriter. On oral argument before the Court of Appeals petitioners conceded that if the WH notes were securities Nuveen was an underwriter. Respondent, with the agreement of petitioners, and by leave of the Court below, has caused a portion of the oral argument below to be transcribed and transmitted to this Court. The relevant colloquy is set forth in the Appendix hereto, A2.

5. "Fraud" and "deceit" as used in § 10b and Rule 10b-5 are not to be equated with the common-law cause of action for fraud, or

(*Continued on next page*)

The Court below looked to the entire statutory scheme and the context of the transaction in weighing the proper application of the 1934 Act. A. 9. In order for an underwriter to sell notes on the basis that they will be paid when due, it must make a reasonable investigation to determine whether the issuer's financial statements possess any integrity. The underwriter should at least determine whether an audit in fact has been made. On the other hand, in the context of the sale of short-term securities, the validity of long-range projections and future business prospects have little significance; the underwriter should not be liable under Rule 10b-5 for a failure to investigate such projections and prospects.

Petitioners contend that if the burden of reasonable investigation of the issuer is placed upon underwriters of commercial paper that financing instrument will be destroyed. Undoubtedly many corporations, underwriters and broker-dealers flocked to the short-term note in order to avoid the expense and burden of registration with the SEC. And, as with other types of securities, numerous defalcations have occurred among issuers of commercial paper.[6] However, the great bulk of commercial

(Continued from preceding page)

the classic tort of deceit. *Blue Chip Stamps, et al.* v. *Manor Drug Stores,* 421 U. S. 723 (1975); *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U. S. 180, 194 (1963).

6. Among the companies that have dishonored their commercial paper are the following. Atlantic Acceptance Corporation, Ltd., see "Report of Atlantic Acceptance Urges Sweeping Rule Changes", N. Y. Times, 12/12/69, p. 89, col. 5; Pioneer Finance Co. ($3 million in commercial paper), see "Pioneer Finance; 'Tight Money' Claims A Casualty", N. Y. Times 9/26/66, p. 63, col. 3; Mill Factors Corporation ($6.7 millions of commercial paper) "Heavy, Heavy . . .", Forbes, 8/15/71", p. 21, "Financial Collapse and Human Tragedy Stalk Mill Factors," N. Y. Times 4/23/69, p. 71, col. 1; Penn Central Transportation Company ($85 million of commercial paper), see Staff Report of the SEC to the Special Subcommittee on Investigations, Committee on Interstate and Freight Commerce, The Financial Collapse of the Penn Central Company (August, 1972); Beverly Hills Bancorporation ($13 millions of commercial paper), see "Bancorp on Coast Reveals Problems", N. Y. Times,

(Continued on next page)

paper is prime paper eligible for discount with the Federal Reserve Bank and is exempt both from the registration and anti-fraud provisions of the 1933 and 1934 Acts. Non-prime commercial paper sold to the public in small denominations through underwriters and dealers on an investment basis is not and should not be exempt from either the registration or anti-fraud provisions. The need of the public for protection from fraud in the sale of such paper is not less than the need for such protection in the sale and distribution to the public of any other type of security. The burgeoning of the market for commercial paper is not an argument for lowering the statutory shield of protection for the investing public.

Contrary to the fears of petitioners and *amici curiae,* the Court below specifically immunized underwriters from the obligations of a guarantor. "Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound." A. 9-10. If the proper examination is made by the underwriter the dishonored notes will not become his obligation.

Nor does the decision below contravene any ruling or expression of this Court in *Blue Chip Stamps.* The reading of *Blue Chip Stamps* by petitioners distorts and misapplies that decision. *Blue Chip Stamps* concerns standing of a plaintiff to sue under § 10(b) or Rule 10b-5, not standards of liability under that section or Rule. There this Court expressly stated: "Blue Chip did not here present the question of whether an implied action under § 10(b) of the 1934 Act and Rule 10b-5 will lie for actions made a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act. We therefore have no occasion to pass on this issue." (citations omitted) 421 U. S. at 752, n. 15.

(Continued from preceding page)

12/31/73, p. 27, col. 7; Franklin N. Y. Corporation, see N. Y. Times, 1/13/75, p. 44 col. 7. Many of these defalcations are discussed in Note, The Commercial Paper Market and the Securities Act, 39 U. Chi. L. Rev. 362, at 378 (1972).

Foremost-McKesson, Inc. v. *Provident Securities Co.*, 44 U. S. L. W. 4056 (January 13, 1976), also relied on by petitioners, deals with the question of standing to sue under § 16(b) of the 1934 Act—a section which imposes absolute liability for violation of its provisions. Determination of liability under § 10(b) and Rule 10b-5 is not reasonably susceptible to the type of absolute treatment applied in *Foremost-McKesson*. Determination of the identity of those a statute is designed to protect involves considerations different in kind from a determination of the conduct the statute prohibits, especially in construing language such as "manipulative or deceptive device or contrivance . . ."

The cases applying § 14 of the 1934 Act, 15 U. S. C. § 78n (proxy violation), are more to the point in the construction of analogous sections of the securities laws than the cases construing § 16(b). In the decision below it is pointed out that in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341, 370 (2d Cir. 1973), *cert. denied*, 414 U. S. 910 (1973), the standards for underwriters expressed in the 1933 Act were used as a guide to determine the liability of an underwriter in a case arising under § 14 of the 1934 Act. A. 8, n.

The decision below is one of reason and common sense, and it is firmly grounded in the statutory scheme of the 1933 and 1934 Acts. Rule 10b-5 was expressly designed to cover the scheme or device that does not fit neatly within the technical provisions of the 1933 Act but which nevertheless operates to deprive the investing public of its protections.

To hold an underwriter liable under Rule 10b-5 for failure to make a reasonable investigation of the issuer is not to imply remedies where none are expressed, but to apply recognized standards of conduct in situations where those standards are necessary for the protection of the investing public.

III. Issues of Scienter and Negligence Are Irrelevant To the Standard of Liability Employed by the Court Below.

Petitioners argue that under Rule 10b-5 there can be no liability without scienter, and proof of negligence is not enough.

Respondent believes the position of petitioners on the need for proof of scienter in a Rule 10b-5 cause of action is erroneous. Petitioners invoke war cries that have long been stilled.[7] More to the point, however, those issues simply are not relevant to the decision below.

Petitioners presumptively anticipate the decision of this Court in *Ernst & Ernst* v. *Hochfelder*, 503 F. 2d 1100 (7th Cir. 1974), *cert. granted*, 421 U. S. 909 (1975) (No. 74-1042), and pray this Court grant the writ and reverse summarily if the Court should require a showing of scienter in that case. That prayer is far-fetched. First, the issue in *Hochfelder* is whether Ernst & Ernst is liable as an aider and abettor of a violator of Rule 10b-5, not whether Ernst & Ernst was a direct perpetrator of a securities act violation in the context of particular transactions. Ernst & Ernst did not sell securities to anyone. Respondent and the members of the represented class purchased their notes directly from Nuveen. In *Hochfelder* there is no nexus of a transaction between Ernst & Ernst and a plaintiff; in this case there is complete privity.

In the securities acts Congress has made the extent of liability imposed upon a participant in a securities transaction dependent

7. Among recent cases holding that specific intent to deceive is not necessary to establish liability under § 10(b) are *Rochez Bros., Inc.* v. *Rhoades*, 491 F. 2d 402, 407-8 (3d Cir. 1974); *Cohen* v. *Franchard Corp.*, 478 F. 2d 115, 123 (2d Cir. 1973), *cert. denied*, 414 U. S. 857 (1973); *Globus* v. *Law Research Service, Inc.*, 418 F. 2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U. S. 913 (1970); *Shapiro* v. *Merrill Lynch*, 495 F. 2d 228, 238-9 (2d Cir. 1974); *Johns Hopkins University* v. *Hutton*, 326 F. Supp. 250, 256 (D. Md. 1971), *aff'd in part and rev'd in part*, 488 F. 2d 912 (4th Cir. 1973), *cert. denied*, 416 U. S. 916 (1974); *Tomera* v. *Galt*, 511 F. 2d 504 (7th Cir. 1975).

upon the culpability of the unlawful conduct and the relationship between the defendant and the transaction that resulted in the plaintiff's injury. The standards of liability range from absolute liability to subtle gradations of negligence. The more direct the relationship, the lesser the culpability required for liability.

The bold assertion that if this Court rules scienter a requirement of proof in *Hochfelder* then this case should be summarily reversed is to swing a very broad axe indeed. A ruling that an aider and abettor must have an intent to deceive has little applicability to the fact situation in this case.

IV. The Decision Below Does Not Enlarge the Statutory Duties of an Underwriter.

Petitioners say that the decision below requires the underwriter to verify the accuracy of the report of an expert such as an independent public accountant. Nothing in the decision below supports that assertion. Underwriters customarily do and must have face-to-face meetings with auditors. In the situations examined by the courts in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341 (2d Cir. 1973), *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E. D. N. Y. 1971); and *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S. D. N. Y. 1968), the underwriters involved each had face-to-face ("due diligence") sessions with the issuer's accountants. Textbooks, manuals and guidelines for underwriters routinely call for such face-to-face sessions.[8] The purpose of these meetings is for the underwriters to determine that the auditor really exists and is competent and independent, and has done his job.

In the instant case the so-called "work papers" of Lieber, Bleiweis were one-half inch thick. A glance at these work papers would have made it known that no audit of WH had

8. See PLI Securities Law Institute—II, The Review of Securities Regulation, 975-77 (V. 7, No. 3, Feb. 6, 1974).

been performed by Lieber, Bleiweis. That was only one of several steps that, if taken, would have uncovered WH's fraud, or raised suspicions which mandated further investigation. Respondent believes that is the correct reading of the decision below on this point.

Nuveen "most likely" did not examine the federal tax returns of WH, although that was Nuveen's accepted procedure. The last two federal tax returns filed by WH did not correspond at all to the audited statements WH sent to Nuveen for those years. Nuveen did not cause the corporate records or contracts of WH to be examined. The corporate records had not been maintained since 1966.

Certainly on these facts the decision below cannot be read as an expansion of the hitherto defined duties of an underwriter.

V. The Decision Sought To Be Reviewed May Be Sustained on Several Grounds Not Reached by the Court of Appeals.

In reaching its decision the Court below assumed or accepted several arguments and contentions advanced by petitioners. If this case is to be reviewed respondent contends that the finding of liability and the judgment entered below may be sustained on grounds not relied on by the Court of Appeals, or on one issue not resolved by the trial court. The judgment of the trial court may be sustained on any ground that is supported in the record. *Jaffke* v. *Dunham*, 352 U. S. 280 (1957).

A. The Lieber, Bleiweis Audit of Winter & Hirsch, Inc. Was Uncertified, or at Best Qualified in Such Manner That Nuveen Could Not Reasonably Have Relied on It.

In checking the creditworthiness of WH Nuveen relied primarily upon annual and semi-annual audit reports which WH sent to it. Those audit reports were completely fictitious and bore no relationship to WH's books and records or to WH's federal income tax returns.

The audit reports were so unusual or peculiar that Nuveen could not reasonably and properly rely on them. Respondent contends and the last credit investigator employed by Nuveen testified that the Lieber, Bleiweis audit reports of WH were uncertified. At best they were qualified audit reports.

Thus a serious question exists in this case as to whether Nuveen met the standard of an underwriter, a broker-dealer, or simply that of a reasonable investor is relying on the audit reports. No one in this case has yet contended that a seller of securities has no obligation of any kind to his buyers. The federal securities acts substitute a policy of full disclosure to investors for the philosophy of *caveat emptor* in the sale of securities. *Affiliated Ute Citizens* v. *U. S.*, 406 U. S. 128,153-4, *reh. denied*, 407 U. S. 916, 408 U. S. 931 (1972).

B. Petitioners Are Liable To Respondent and the Class Represented by Respondent for Nuveen's Failure To Comply with Rule 27 of the National Association of Securities Dealers.

Rule 27 of the National Association of Securities Dealers ("NASD") requires that a securities dealer adopt and promulgate written procedures to be followed in selling securities, and to properly supervise its salesmen. The rules of the NASD were promulgated pursuant to § 15A of the 1934 Act, 15 U. S. C. § 78o-3. Violation of those rules provides a basis for private damage actions. *SEC* v. *First Securities Company of Chicago*, 463 F. 2d 981 (7th Cir. 1972) *cert. denied sub nom. McKy* v. *Hochfelder*, 409 U. S. 880 (1972). Nuveen failed to establish, maintain and enforce written procedures for the sale of investment securities, or properly to supervise the salesmen employed by it in the sale of the short-term notes here at issue, and is liable for that failure.

C. Nuveen Misrepresented WH Commercial Paper and Omitted To State Material Facts Necessary To Make the Statements Made Not Misleading in Violation of Section 12(2) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5.

Respondent proved direct misrepresentations made by Nuveen salesmen to various members of the class in connection with the sale of WH notes to them. In addition, Nuveen did not communicate to purchasers of WH notes the fact that those notes were only rated "desirable" rather than "prime" and were more speculative with greater attendant risks than prime paper. That was an omission to state a material fact necessary to make the statements made not misleading.

Should the writ of certiorari issue, respondent will request this Court to sustain the judgment for respondent and the members of the class on the ground that the misstatements of and omissions to state material facts in connection with the sale of WH notes to respondent and the represented class are violations of § 12(2) of the 1933 Act as well as of § 10(b) of the 1934 Act and Rule 10b-5.

CONCLUSION.

Respondent prays that the Petition For A Writ Of Certiorari be denied.

Respectfully submitted,

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APPENDIX TO BRIEF FOR RESPONDENT IN OPPOSITION.

RULE 27 OF ARTICLE III OF THE RULES OF FAIR PRACTICE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

SUPERVISION.

Written procedures.

(a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

Responsibility of member.

(b) Final responsibility for proper supervision shall rest with the member. The member shall designate a partner, officer or manager in each office of supervisory jurisdiction, including the main office, to carry out the written supervisory procedures. A copy of such procedures shall be kept in each such office.

Written approval.

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Review of activities and annual inspection.

(d) Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction.

Qualifications investigated.

(e) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications and experience of any person prior to making such a certification in the application of such person for registration with this Association.

Office of supervisory jurisdiction.

(f) "Office of supervisory jurisdiction" means any office designated as directly responsible for the review of the activities of registered representatives or associated persons in such office and/or in other offices of the member.

EXCERPTS FROM ORAL ARGUMENT BEFORE THE UNITED STATES COURT OF APPEALS.

Mr. Horwich (for Defendants-Appellants): "This case deals with the question of the responsibility of a broker-dealer selling commercial paper. It pertains to a class action brought by approximately 43 class members against the broker-dealer and alleged controlling persons in connection with the sale of commercial paper of a small consumer finance company, Winter & Hirsch. . . .

". . . There is a separate basic issue on each of the two appeals. The basic issue on the first appeal from the basic judgment in favor of the class against the defendants is whether a broker-dealer selling commercial paper has a responsibility to discover a joint fraud conducted by the issuer and the issuer's auditor."

The Court: "Do you dispute the fact that the broker-dealer is an underwriter?"

Mr. Horwich: "I do not. I think that under Section 2(11) Nuveen was probably a statutory underwriter."

The Court: "Probably, or do you agree that he was an underwriter?"

Mr. Horwich: "I would agree."

The Court: "You don't challenge that conclusion of law?"

Mr. Horwich: "No, but I do not think that that affects the standard of liability that is placed on Nuveen in this situation."

The Court: "Is that an issue, though, whether it does? They argue otherwise, I think, on that."

Mr. Horwich: "Yes, they do, your Honor. But we believe that the principal provision on which the District Court relied —plaintiffs relied—Section 11—has no application to this case for several primary reasons. The first one is—there is no registration statement here."

The Court: "I understand that, but do you agree that even if the case is simply a 10b-5 case, the standard of care for an underwriter is the same as the standard of care for a broker-dealer?"

Mr. Horwich: "If it's an underwriter outside the context of Section 11, I don't believe that there is any difference in the standard. I think whether or not it's a statutory underwriter is really immaterial in determining the standard there."

Supreme Court, U. S.
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IN THE

Supreme Court of The United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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REPLY BRIEF OF PETITIONERS

The Brief for Respondent in Opposition ("Brief in Op.")* at best gives only a superficial reply to the arguments advanced by petitioners demonstrating the need for review by this Court. Respondent's inability to meet petitioners' arguments regarding the duty of a commercial paper dealer is typified by the absence of apposite citations. Accordingly, only a few points made by respondent merit a response at this time.

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* Other abbreviations used herein are the same as those used in the Petition. The "1934 Act" is the Securities Exchange Act of 1934; the "1933 Act" is the Securities Act of 1933; and *Sanders I* is the first Court of Appeals opinion herein.

I.

The reply to petitioners' contention that the notes purchased by the class members are not "securities" within the meaning of Section 3(a)(10) of the 1934 Act merely emphasizes the infirmities in the decision below.* For example, respondent states, "The date of maturity of the note is not meaningful . . ." (Brief in Op., page 6). This concedes the fact, recognized in some decisions construing Section 3(a)(10), that the statutory exclusion or inclusion of notes based solely on their maturity has been emasculated by decisions such as *Sanders I* (Pet., page 11).

Respondent contends that the decision below will have no significant effect upon the commercial paper market, that "the great bulk of commercial paper" is exempt (Brief in Op., pages 10-11) and that "[*p*]*resumably* all such [non-exempt] investment paper is now being registered with the SEC before being sold to the public" (Brief in Op., page 8, emphasis added). Respondent's confidence in the ability of a dealer to determine the availability of an exemption (and thus whether registration is required) is neither supported by the record nor shared by movant** Lehman Commercial Paper Incorporated. The latter, with petitioners, contends that the decision below will have a significant impact, particularly with respect to the risk presented by a hindsight or retroactive determination that paper reasonably thought at the time of sale to be exempt was actually non-exempt, because of facts not known to the dealer. *See* Pet., pages 24-26; brief of Lehman Commercial Paper Incorporated, amicus curiae, pages 12-14. *See also* brief of Securities Industry Association, amicus curiae, pages 10-11. Petitioners submit that review by this Court is necessary to resolve such dilemmas.

* The suggestion that, as a matter of policy, this Court should not now review an issue that was the subject of an interlocutory appeal (Brief in Op., page 6) is at odds with the long-standing practice of this Court. *See* Pet., page 9 at note *, and *Hamilton-Brown Shoe Co.*, v. *Wolf Bros. & Co.*, 240 U.S. 251, 258 (1916).

** Lehman Commercial Paper Incorporated and the Securities Industry Association have each filed motions for leave to file a brief as an amicus curiae. These motions have not yet been ruled on. References herein are to the briefs which the amici curiae have sought leave to file.

II.

Respondent never meets petitioners' arguments (Pet., pages 18-21) demonstrating that the court below concluded too much from its determination that Nuveen was within the 1933 Act definition of "underwriter", a misunderstanding on the part of the court foreshadowed in the portion of the oral argument quoted by respondent (Brief in Op., pages A2-A3). As indicated by petitioners at oral argument below and in the Petition, the statutory definition of "underwriter" is meaningful with respect to certain provisions of the 1933 Act but has no significance under Rule 10b-5.

Respondent contends that Nuveen was properly held liable for failing to do what "[u]nderwriters customarily do", citing three cases involving registered public offerings (Brief in Op., page 14).* The decision below cannot be supported by repeating its errors.

III.

Respondent's remaining arguments may be dealt with summarily.

A.

Respondent attempts to justify the duties imposed upon Nuveen on the ground that Nuveen sold the notes on the

* Similarly, in opposing the motion of the Securities Industry Association as amicus curiae respondent refers to "[s]tandard underwriting procedure" (Objections to Motion of Securities Industry Association, page 2).

basis "that there should be no question but what the paper will be paid at maturity" (Brief in Op., page 9). In relying on that statement (App. 2), the Court of Appeals treated it as if it had been a representation communicated to purchasers rather than, as it was, merely a statement made by the head of the Nuveen commercial paper department to the president of Winter & Hirsch when he explained why Nuveen ceased selling Winter & Hirsch commercial paper (Pet., page 6). It was an expression of Nuveen's ultimate goal in the sale of commercial paper and did not constitute any assumption of an obligation such that failure to meet the goal could result in civil liability.

B.

Respondent's effort to distinguish *Ernst & Ernst v. Hochfelder*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042) (Pet., pages 12-15; Brief in Op., page 13), is without merit. The cases are not as dissimilar as respondent suggests. Ernst & Ernst was without knowledge of the fraud at issue in that case (503 F.2d 1104); in this case Nuveen had no knowledge of the fraud perpetrated by an issuer and its accountant, a lack of knowledge which the Court of Appeals recognized was "honest". For that reason and the reasons stated in the Petition, the decision in *Ernst & Ernst* will have a direct bearing on, and may be dispositive of, this case.

C.

Any contention that the decision below places no duty on a dealer in commercial paper to verify the accuracy of the report of the auditor but only requires an interview of him (Brief in Op., pages 14-15) is without support in the opinion

below and is contrary to the facts of the case.* The decision below expressly held that, despite Nuveen's mistaken but honest belief in the accuracy of the financial statements (App. 1), it should have examined the auditor's working papers (App. 4). If the decision stands, the dealer who honestly relies on certified financial statements of the issuer and has no reason to suspect fraud, but who fails to take any step which might possibly occur to one "with a question of fraud in mind" (App. 10), can never be sure that he has fulfilled his Rule 10b-5 duties as an "underwriter". *See* brief of Securities Industry Association, page 16.

The decision below has been widely understood as creating a very broad responsibility.** Review should not be denied simply because in respondent's view it is capable of a narrower reading.

D.

In asserting that the decision below is sustainable on alternative grounds respondent begs essential questions. The alternative grounds which are predicated on violations of provisions of the 1934 Act fall if the commercial paper at issue was not a security or if a showing of *scienter* is required to establish liability. The lone ground under the 1933 Act, that Nuveen is liable under Section 12(2), was rejected by the Court of Appeals since the District Court made no supporting findings (App. 6), as respondent recognizes (Brief in Op., page 15).

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* The record shows that when a meeting was held between a lender to Winter & Hirsch, the First National Bank of Chicago, and Lieber, Bleiweis after the lender heard rumors of a problem at Winter & Hirsch, the auditor was able to allay any concern expressed by the representative of the lender, a senior bank officer (App. 23-24).

** New York Law Journal, 1/21/76, pages 1-2; Securities Regulation & Compliance Bulletin, pages 2-4 (Prentice Hall 12/18/75); Securities Regulation and Transfer Report, pages 1-2 (Management Reports, Inc. 12/18/75). *See also* brief of Securities Industry Association, amicus curiae, pages 13-14.

CONCLUSION

For the reasons given herein and in the Petition for Certiorari, we pray that the writ be granted.

Respectfully submitted,

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MOTION FILED
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IN THE

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OCTOBER TERM, 1975

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Petitioners,

—v.—

HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF LEHMAN COMMERCIAL PAPER INCORPORATED AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Aug. 1972) 7

IN THE

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HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Motion of Lehman Commercial Paper Incorporated for Leave to File Brief as *Amicus Curiae*

Pursuant to Rule 42(3) of the Rules of this Court, Lehman Commercial Paper Incorporated, of 20 Exchange Place, New York, New York, hereby respectfully moves for leave to file the within brief *amicus curiae* in support of the Petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case. The consent of the Petitioners to the filing of such brief has been obtained. The consent of the Respondent was requested but was not obtained.

Status and Interest of Lehman Commercial Paper Incorporated

Lehman Commercial Paper Incorporated ("LCPI"), a subsidiary of Lehman Brothers Incorporated, investment banker, is a broker-dealer engaged in the sale of commercial paper, bankers acceptances and other money market instruments.

LCPI is one of the nation's principal commercial paper dealers. It acts as dealer for more than 100 commercial paper issuers, including many of America's leading industrial and utility companies. The aggregate amount of the commercial paper sold by LCPI and currently outstanding exceeds $2 billion, constituting approximately 12% of all outstanding commercial paper sold by dealers in the United States.

LCPI is directly affected by developments in the Federal securities laws involving commercial paper and the obligations and potential liabilities of dealers therein. The decision below—holding in substance that commercial paper notes sold by dealers may constitute "securities" for purposes of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and that a commercial paper dealer is an "underwriter" of such securities subject to liability under Rule 10b-5 for failure to make an adequate investigation of the issuer, even without a showing of actual fraud or reckless or willful conduct—is the most significant judicial pronouncement in this area in recent years.

LCPI believes that the decision of the Court of Appeals in this case did not give adequate recognition to the nature and special features of the commercial paper market, and that the decision will expose commercial paper dealers such

as LCPI to unreasonable burdens and risks of liability. Accordingly, LCPI requests leave to submit this brief as *amicus curiae* to call these matters to the attention of the Court.

Respectfully submitted,

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HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF LEHMAN COMMERCIAL PAPER INCORPORATED AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

The interest of Lehman Commercial Paper Incorporated as *amicus curiae* is set forth in the preceding motion for leave to file this brief.

Opinions Below

The Court of Appeals has rendered two opinions in this action. In its initial opinion (hereinafter, *"Sanders I"*), reported at 463 F.2d 1075 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972), it held that the short-term notes of Winter &

Hirsch, Inc. sold by Petitioner Nuveen to the Respondent were "securities" under the Securities Exchange Act of 1934[1] and Rule 10b-5[2] thereunder. In its more recent opinion (hereinafter, "*Sanders II*"), not yet officially reported,[3] the Court of Appeals reaffirmed the position it had adopted in *Sanders I* on the applicability of Rule 10b-5 to the Winter & Hirsch notes, and further held that Petitioner Nuveen was an underwriter of such notes and therefore liable to purchasers of the notes under Rule 10b-5 because, in the opinion of the Court of Appeals, it had failed to make an adequate investigation of the financial position of the issuer.

Questions Presented, Statutes and Rule Involved and Statement of the Case

In the interest of brevity, the statements contained in the Petition for a Writ of Certiorari (the "Petition") filed by the Petitioners John Nuveen & Co., Inc. ("Nuveen"), Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. with respect to the Questions Presented, Statutes and Rule Involved, and Statement of the Case are hereby adopted.

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[1] 15 U.S.C. §78a *et seq.*

[2] 17 C.F.R. §240.10b-5. Rule 10b-5 was promulgated by the Securities and Exchange Commission under the authority granted to it by §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b).

[3] This opinion is unofficially reported at CCH FED. SEC. L. REP. ¶95,347 [Current Binder]. The *Sanders I* and *Sanders II* opinions are printed in the appendix to the Petition for a Writ of Certiorari herein.

REASONS FOR GRANTING THE WRIT

Introduction: The Commercial Paper Market

Commercial paper consists of short-term, promissory notes, normally unsecured, issued by finance, industrial, utility, mercantile and other companies and by affiliates of commercial banks. Paper of the larger finance companies and affiliates of commercial banks generally is issued directly to the purchaser by the issuer. The balance of commercial paper, including substantially all paper issued by non-financial companies, is issued through commercial paper dealers ("dealer paper"). Approximately six commercial paper dealers, including LCPI, account for most of the dealer paper sold in the United States.[4]

Dealer paper has played an increasingly important role in our country's money markets. From 1966 to 1975, the average dollar amount of such paper outstanding has grown from approximately $3 billion to over $17 billion.[5] For issuers, commercial paper serves as an important complement to conventional bank borrowings as a source of short-term funds to finance inventories, receivables and other working capital requirements. For banks, the availability of the alternative form of short-term financing accorded to borrowers by the commercial paper market significantly reduces pressures that otherwise would be imposed on the banking system to furnish short-term capital, particularly

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[4] *See* Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, at 367 n. 30 (1972); *see also* STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY, 274 (Aug. 1972).

[5] 61 FEDERAL RESERVE BULLETIN A-25 (December 1975).

in times of tight money. For purchasers, commercial paper provides a means by which excess funds that might otherwise be idle can be put to work in the short-term money market.

The commercial paper market, by providing an alternative to bank borrowings as a source of required short-term funds, materially enhances the liquidity of American business. The continued vitality of such market is thus of major importance to our economy.

The dealer, through his capital, his knowledge of the market and his distribution facilities, is the cornerstone of the commercial paper market. In almost all cases, the dealer acts as principal, purchasing the commercial paper notes for his own account from the issuer and reselling the notes to purchasers. He receives compensation by purchasing from the issuer at a discount calculated to produce a yield somewhat higher (normally ⅛ of 1% computed on an annual basis) than the estimated current market yield. The dealer may then resell the paper at the market price. In many instances, however, the dealer will not have arranged a resale at the time of his purchase from the issuer; the dealer's capital is therefore at risk in fluctuating markets. A dealer will typically carry ("position") a substantial inventory of paper running into several hundred million dollars. The dealer must himself arrange to finance his positions, and, when market conditions are unfavorable, the cost of such financing may exceed the yield to the dealer on the paper he carries. Despite such costs, the dealer must be prepared to position paper in order to assure issuers that the funds required by them will be available as and when needed.

The anticipated compensation to the dealer from the sale of commercial paper is significantly less than an underwriter's normal spread or profit in an underwritten sale of debentures, bonds or equity securities.[6] The market risks and interest costs of carrying large positions of commercial paper can materially reduce such compensation or result in losses to the dealer.

Commercial paper is rated by one or more of three nationally recognized rating agencies.[7] Most paper sold is rated in one of the three highest categories by at least one such agency.[8] In addition, dealers make and periodically update their own credit analyses of the issuers whose paper they sell, in the course of which they customarily review, among other things, the issuer's audited year-end financial statements, interim unaudited statements, bank lines, borrowings and other items, and make inquiries of officers of the issuer.

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[6] The normal underwriters' spread on long-term bonds is 7/8 of 1% of the face amount of the bonds. Thus, assuming an issue of $10,000,000 of long-term bonds, total underwriter compensation would be $87,500. By contrast, the compensation to a dealer from a $10,000,000 issue of commercial paper having a maturity of 90 days would be approximately $3,125. The discrepancy between underwriters' compensation in equity offerings and dealer compensation from the sale of commercial paper is even greater.

[7] Standard and Poor's Corporation, Moody's Investors Service, Inc. and Fitch Investors Service.

[8] Beginning January 1, 1976, as a result of the adoption by the Securities and Exchange Commission of amendments to its rules imposing minimum net capital requirements on broker-dealers (Rule 15c3-1 under the Securities Exchange Act of 1934, 17 C.F.R. 240. 15c3-1), dealer paper will be required to be rated by at least two such agencies.

I.

The Court Below Erred in Reading into Section 3(a)(10) of the Securities Exchange Act the Limitations of the Commercial Paper Exemption Under the Securities Act of 1933.

In *Sanders I* (reaffirmed by *Sanders II*) the Court of Appeals held that a promissory note having a maturity at the time of issuance of not more than nine months constituted a "security" for purposes of the Securities Exchange Act of 1934, 15 U.S.C. §78a *et seq.* (the "1934 Act"), and Rule 10b-5, 17 C.F.R. §240.10b-5 ("Rule 10b-5") thereunder, notwithstanding the fact that Section 3(a)(10) of the 1934 Act[9] expressly provides to the contrary. In so holding, the Court of Appeals, looking to its conception of "economic reality," concluded that the exclusion for short-term notes in Section 3(a)(10) applies only to commercial paper notes of the kind exempted from provisions of other Federal securities laws, particularly Section 3(a)(3) of the Securities Act of 1933[10] (the "1933 Act"), which exempts from registration under the 1933 Act short-term notes arising out of "current transactions."

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[9] Section 3(a)(10) of the 1934 Act states that as used in that Act the term "security" shall not include "any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . . " 15 U.S.C. §78c(a)(10).

[10] Section 3(a)(3) of the 1933 Act exempts from the registration provisions (Section 5) of that Act any note "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months. . . . " 15 U.S.C. §77c(a)(3).

It is submitted that the unqualified exclusion in Section 3(a)(10) of the 1934 Act for "any" note having a maturity of nine months or less cannot properly be interpreted to cover only short-term notes of the kind exempted from the registration provisions of the 1933 Act. Such a limitation not only does violence to the express language of the statute, but is not supported even by the reasoning employed by the Court of Appeals in reaching this result. In its analysis, the Court of Appeals attempted to weave a common thread linking the coverage of the antifraud provisions of the 1933 Act with that of Section 10(b) of the 1934 Act. The court concluded that Congress could not have intended to exempt from Section 10(b), the antifraud provision of the 1934 Act, short-term notes which would not be exempt from the antifraud provisions of the 1933 Act. However, the court's attempt to equate the coverage of the antifraud provisions of the two Acts cannot be sustained because notes qualifying for the 1933 Act's Section 3(a)(3) commercial paper exemption, which under the court's reasoning would appear to remain exempt from Section 10(b) and Rule 10b-5, would still be subject to the 1933 Act's antifraud provisions (Sections 12(2) and 17).[11]

Moreover, the Court of Appeals—while doing violence to the statutory language by holding that short-term notes not entitled to the 1933 Act's registration exemption are subject to Rule 10b-5—added little if any protection to the purchaser of such notes: if the registration exemption is not available, the purchaser has the much clearer remedy of suing for rescission under Section 12(1) of the 1933 Act for failure to register the notes;[12] and even if the notes were

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[11] 15 U.S.C. §§77*l*(2) and 77q.

[12] Section 12(1) of the 1933 Act is quoted in note 16 *infra*.

registered, there would be no need to stretch to reach Rule 10b-5, since the antifraud provisions of the 1933 Act would expressly apply.

II.

In Determining the Availability of the Commercial Paper Exemption of the 1933 Act, the Court Below Applied Criteria That Make Commercial Paper Dealers Virtual Insurers.

If it is assumed, *arguendo,* that the limitations of Section 3(a)(3) of the 1933 Act can be imported into Section 3(a)(10) of the 1934 Act, nevertheless, the criteria adopted by the Court of Appeals, in its analysis of Section 3(a)(3), would make it impossible for any commercial paper dealer to determine in advance whether the paper it sells is exempt from registration under the 1933 Act and, as a practical matter, would make dealers virtual insurers of the paper they sell.[13]

The Court of Appeals, applying Securities and Exchange Commission Release No. 33-4412,[14] interpreting Section 3(a)(3) of the 1933 Act, stated that Section 3(a)(3) exempted from registration only "prime quality negotiable commercial paper" issued to facilitate "current operational business requirements" and of a type eligible for discounting by Federal Reserve banks. In determining whether the

[13] To the best of LCPI's knowledge, dealer paper is uniformly sold without registration, in reliance on the commercial paper exemption from the 1933 Act. Because of problems of timing and expense, it would be wholly impractical, for both the issuer and the dealer, to seek to register such notes.

[14] 17 C.F.R. §231.4412.

notes in the instant case met these requirements the Court of Appeals reasoned:

> "Thus, *because of the company's insolvency, it seems highly unlikely* that the paper purchased by the plaintiff and members of his class is either prime quality or issued to facilitate current transactions or eligible for discounting by Federal Reserve banks."[15] (Emphasis added.)

Under this retroactive analysis, if an issuer of commercial paper notes should default at some future time in payment of the notes, then the exemption from registration was not available at the time the notes were issued. Since no investigation by a dealer at the time of issue, no matter how thorough, can *guarantee* that the issuer is or will remain solvent and will pay the notes at maturity, *the dealer cannot know at the time he sells a note that it is exempt from registration.* If he nevertheless takes the risk of selling the notes in reliance on the exemption, and the issuer becomes insolvent, *the dealer will have no defense to a suit by the purchaser under Section 12(1)* of the 1933 Act for having sold the notes in violation of the registration provisions of the Act.[16] In short, if the decision of the Court of Appeals is permitted to stand, possible liability under Rule 10b-5 upon a default by the issuer—with which the

[15] 463 F.2d at 1079.

[16] Section 12 of the 1933 Act, 15 U.S.C. §77*l*, provides that "Any person who (1) offers or sells a security in violation of [section 5, 15 U.S.C. §77e] . . . shall be liable to the person purchasing such security from him, who may sue . . . to recover the consideration paid for such security with interest thereon . . . upon the tender of such security, or for damages if he no longer owns the security."

Court of Appeals was concerned—would be of academic interest to the dealer since he would have strict liability under Section 12(1) of the 1933 Act. Clearly, this impossible and unfair burden imposed on the dealer could not have been intended by Congress and is likely to have a significant chilling effect on the willingness of commercial paper dealers to continue to undertake the risks associated with the commercial paper market.

III.

The Opinion Below Imposes an Unreasonable Standard of Liability on Commercial Paper Dealers Under Rule 10b-5.

In *Sanders II*, the Court of Appeals, while stating that it was avoiding the "broad question" whether the standard of liability under Rule 10b-5 "lies somewhere between the extremes of common law fraud on the one hand and mere negligence on the other," held that a commercial paper dealer is liable under Rule 10b-5 if he fails to make a "reasonable" or "adequate" investigation of the issuer, thereby adopting a standard of culpability clearly based on ordinary negligence. In arriving at its conclusion the Court of Appeals applied, for Rule 10b-5 purposes, concepts created by and peculiar to the 1933 Act, *viz.* the obligation imposed by Section 11 of that Act[17] on an underwriter of a registered public offering to make a reasonable investigation of the accuracy of the registration statement. Thus, the Court of Appeals, describing Nuveen (the commercial paper dealer) as an "underwriter", relied on precedents dealing with the (Section 11) "due diligence" obligation of underwriters of registered public offerings (*Feit* v.

[17] 15 U.S.C. §77k.

Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), and *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968)) to hold that Nuveen was under a duty, enforceable through Rule 10b-5, to make an adequate investigation of the issuer.

It is submitted that, for the reasons set forth in the Petition (which in the interest of brevity will not be expanded here), the use of Section 11 precedents to determine the liability of a commercial paper dealer under Rule 10b-5 of the 1934 Act is wrong as a matter of law. In addition, the Court of Appeals' assumption that a commercial paper dealer is in the same position as an underwriter of a registered public offering is incorrect as a matter of economic reality. The commercial paper dealer does not prepare a prospectus and thus does not have the assistance of legal counsel in the preparation of a prospectus, as does an underwriter in a public offering; the commercial paper dealer's compensation is significantly less than the normal underwriting compensation;[18] the substantial legal and other costs associated with an underwritten offering could not be undertaken in a commercial paper transaction without rendering the transaction wholly impractical to both the issuer and the dealer; and, unlike an underwritten transaction, sales of commercial paper are conducted on a recurring basis over a substantial period of time so that a dealer subject to a "due diligence" obligation would be required continuously to be performing the kinds of investigations that a court or jury might deem appropriate for an underwriter.

Moreover, the specific investigation that the Court of Appeals here found necessary has not previously been ap-

[18] See note 6 *supra*.

plied even to traditional underwriters. The Court of Appeals concluded that Nuveen's investigation was deficient because it did not seek to examine the issuer's income tax returns or its auditor's work papers.[19] Yet these are items that underwriters ordinarily would have no reason to examine since they are not experts in accounting or tax matters and could not expect to obtain meaningful information from such papers. Absent some reason to believe that the financial statements are inaccurate, an underwriter is entitled, under the 1933 Act, to rely on the reports of auditors who are experts on such matters.[20]

The essential difficulty with the Court of Appeals' approach is that, in the event an issuer should fail to pay its maturing commercial paper, a court or jury is invited, with the benefit of hindsight, to find a deficiency in the dealer's investigation: whatever the dealer in fact investigated, no matter how thorough and diligent he was at the time, it will likely be found that he should have examined something else which (in the words of the Court of Appeals) "would have revealed the fraud or at the very least would have revealed deficiencies that would have mandated further inquiry."

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[19] The Court of Appeals also contended that Nuveen should have reviewed the issuer's minute books. Minute books typically are reviewed by counsel in an underwriting.

[20] Section 11(b)(3)(C), 15 U.S.C. §77k(b)(3)(C).

CONCLUSION

For the reasons set forth above, LCPI joins in the request of the Petitioners that a writ of certiorari be granted to review the opinions below.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-1065

JOHN NUVEEN & CO., INC., A CORPORATION, INVESTORS SYNDICATE OF AMERICA, INC., A CORPORATION, AND INVESTORS DIVERSIFIED SERVICES, INC., A CORPORATION,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

OBJECTIONS TO MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

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Respondent by his attorneys, objects to the motion of the Securities Industry Association ("SIA") for leave to file a brief as *amicus curiae* in support of the petition for Writ of Certiorari. In support of his objections respondent states as follows.

SIA makes no showing, as required by Rule 42(3), that petitioner will not make an adequate presentation of the facts and law to be reviewed. SIA does, however, seek to have this Court consider issues that are not present in the case.

SIA in its motion contends that it and its members have a substantial interest in the granting of the petition because, "The decision below has the effect of making dealers in short term notes virtual guarantors of payment of such notes." Motion, 2. In the decision below an underwriter of dishonored commercial paper was held liable for failing to make the examination of the issuer of securities required under the federal securities acts. The record, which the Petitioners have not placed before this Court, fully reveals the deficiencies in the examination of the issuer made by the underwriter.

The decision below does not, as SIA contends, affect "dealers in short-term notes." Moreover, the decision below does not make anyone a guarantor. The decision below determined liability for failure of an underwriter to fulfill statutory duties.

SIA further contends that the decision below enlarges the statutory obligations and liabilities of underwriters of securities by undermining "the right of an underwriter to rely upon experts and specifically, to rely upon financial statements certified by independent public accountants." The fact is that the underwriter found liable below never verified that an audit had been performed. The underwriter didn't know the auditor, never met or spoke with the auditor and did not glance at the auditor's work papers, which would have revealed than an audit had not been performed. Standard underwriting procedure calls for face-to-face meetings with the auditor. The Court below imposed liability for the underwriter's failure to fulfill these rudimentary requirements. In light of these facts it cannot be said that the decision below requires an underwriter to "audit the auditors".

The standards of 'reasonable investigation' to which the Court below held the underwriter have been acknowledged and applied with uniformity by all Courts having occasion to rule on them. Since all parties acknowledged below that the role of John Nuveen & Co., Inc. in connection with the sale of

the commercial paper involved was that of an underwriter, the issue resolved below was whether or not the underwriter made the reasonable investigation of the issuer mandated by the federal securities acts.

The would-be *amici* seek to use this case to argue issues that to them apparently are important. Those issues, however, are not found in the decision and the record below. For these reasons the motion of SIA for leave to file its *amicus curiae* brief should be denied.

Respectfully submitted,

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Petitioners,

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HENRY T. SANDERS,

Respondent.

MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE BRIEF AND BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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IN THE

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OCTOBER TERM, 1975

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—v.—

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Respondent.

MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Securities Industry Association ("SIA" or "Association") respectfully moves, pursuant to Rule 42 of the Rules of this Court, for leave to file a brief *amicus curiae* in support of the petition for a writ of certiorari of John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. ("Petitioners"). Petitioners have consented to filing of an *amicus* brief by SIA; respondent has refused such consent.

SIA is a trade association with some 650 members engaged in the securities business; its members are located throughout the United States. SIA was formed in 1972 through merger of the Association of Stock Exchange Firms and the Investment Bankers Association of America. Among the members of SIA are all the principal commercial paper dealers in the United States. Petitioner

John Nuveen & Co., Inc. ("Nuveen"), a member, presently is engaged principally in the purchase and sale of municipal securities and securities of the United States Government and agencies thereof, and sale of securities of municipal bond funds; the Association's broker/dealer membership typically includes firms more broadly engaged in the securities industry than is Nuveen. SIA is widely recognized as a securities industry spokesman to the public and to Government.

Applicant and its members have a substantial interest in the granting of the petition because:

(1) The decision below has the effect of making dealers in short-term notes virtual guarantors of payment of such notes. The volume of such dealer paper outstanding at the end of September, 1975, exceeded seventeen billion dollars, and SIA members handled an estimated 90% of that dealer business.

(2) The decision below enlarges statutory obligations and liability of underwriters of and dealers in all securities, by undermining the right of persons engaged in the distribution of securities to rely upon the authority of experts, despite specific provisions in the Securities Act of 1933 authorizing such reliance, and does so in circumstances where no reason was found to exist before sale of the notes to question the financial statements certified by independent public accountants.

(3) The decision below effectively holds securities underwriters and dealers who operate in a national market to standards materially different from those enunciated by

other courts of appeals, thereby leaving great uncertainty as to obligations of SIA's members, and making liability for their conduct under federal securities law dependent upon the fortuity of where they may be sued.

By the accompanying brief, SIA seeks to bring to the Court's attention the pervasive ramifications of the decision below upon distribution of securities through underwriters and dealers and to emphasize certain legal issues of critical importance to the securities industry. It is urged that the Court grant SIA's motion for leave to file the attached brief in support of the petition for a writ of certiorari herein.

February 2, 1976

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HENRY T. SANDERS,

Respondent.

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

On behalf of members of the securities industry engaged in virtually all facets of the capital formation process, the Securities Industry Association ("SIA") urges as *amicus curiae* that the Petition for a Writ of Certiorari should be granted. The decision of the Court of Appeals for the Seventh Circuit improperly imposes—under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), the sole basis for liability below—obligations and risks of liability upon underwriters, and upon dealers in commercial paper (and, inferentially, other securities), which are unwarranted under §10(b) of the Securities Exchange Act and contrary to provisions of §11 of the Securities Act of 1933, 15 U.S.C. §77k.

Opinion Below

There are two opinions by the Court of Appeals: *Sanders* v. *John Nuveen & Co., Inc.,* 463 F.2d 1075 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972), hereinafter called *"Sanders I"*; and *Sanders* v. *John Nuveen & Co., Inc.,* 524 F.2d 1064 (7th Cir. 1975), hereinafter called *"Sanders II"*. The opinions respectively are at page 49, *et seq.*, and page 1, *et seq.*, of the Appendix to Petition for a Writ of Certiorari filed by John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. ("Petitioners").

On certification pursuant to 28 U.S.C. §1292(b), the Court of Appeals held in *Sanders I,* 463 F.2d at 1077-81, *inter alia,* that purchasers from John Nuveen & Co., Inc. ("Nuveen") of ninety-day promissory notes that were not paid when due by the issuer, Winter & Hirsch, Inc. ("WH"), could maintain a damage action against Nuveen under §10(b) of the 1934 Act, despite the 1934 Act exemption from the definition of a "security" for "any note . . . which has a maturity at the time of issuance of not exceeding nine months," 15 U.S.C. §78c(a)(10).

Subsequent proceedings in the District Court resulted in the determination that Nuveen, and related defendants who allegedly controlled Nuveen, were liable for the face amount of the defaulted notes Nuveen had sold, plus interest thereon. On review by the Circuit Court in *Sanders II,* it was held that, ". . . Nuveen's liability in this case must rest on Rule 10b-5." 524 F.2d at 1069 (footnote omitted).

Questions Presented and Statutes Involved

The statement of Petitioners of the questions presented herein includes the three issues that SIA, as *amicus curiae,* urges are of importance: (1) whether short-term promissory notes are excluded from the ambit of the 1934 Act; (2) whether participants in the distribution of securities (other than the issuer) may rely upon reports of experts; and (3) what standards of conduct should be utilized to measure liability under §10(b) of the 1934 Act. In the interest of brevity, Petitioners' statement of those questions (Petition, pp. 2-3) is adopted. However, because of the interest of SIA and its members in potentially broader ramifications of the answers to certain of these questions, its discussion of those issues (Argument, Points II and III, *infra*) is in the context of securities generally, and is not restricted to short-term notes.

Relevant sections of the Securities Act of 1933 and Securities Exchange Act of 1934 are specified by Petitioners (Petition, p. 3) and included in the Appendix (p. 69, *et seq.*) to their Petition.

Statement of the Case

We adopt the recitation of relevant facts as set forth by Petitioners in their Statement of the Case (Petition, pp. 3-8). We wish to emphasize, however, that the court below specifically found that: The issuer of the short-term notes here involved, WH, was "an old established firm with a fine reputation"; and, in dealing in WH paper, Nuveen "acted in the mistaken but honest belief that financial statements prepared by [WH's] certified public accountants correctly represented the condition of the issuer." *Sanders II,* 524 F.2d at 1071, 1066.

ARGUMENT

I

This Court should determine whether short-term notes are securities within the ambit of the 1934 Act.

As noted, the sole basis for the Circuit Court's conclusion that Nuveen is liable is §10(b) of the 1934 Act and Rule 10b-5 thereunder. Section 10(b) in terms applies to transactions "in connection with the purchase or sale of any security", 15 U.S.C. §78j(b). However, §3(a)(10) of the 1934 Act specifically defines "security" so as to exclude, without qualification, notes with "a maturity at the time of issuance of not exceeding nine months", 15 U.S.C. §78c (a)(10).* Since short-term notes (which constitute "commercial paper") are unequivocally removed from the coverage of the 1934 Act, a serious issue obviously arises as to whether that statute may be construed, contrary to its express terms, to apply to the sale of commercial paper.

In reaching a conclusion purportedly based upon, but in fact specifically contrary to, the provisions of the 1934 Act, the court below sought support for its conclusion in a policy of interpreting broadly the federal securities laws in aid of remedial objectives. To this end it relied heavily upon

* It is significant, in this connection, to compare the language of §3(a)(10) of the 1934 Act (defining the scope of the statute's coverage) with the language of §3(a)(3) of the 1933 Act affording only an exemption from the requirements of the registration provisions of that Act. In the 1933 Act, only short-term notes issued in connection with a "current transaction" are exempted and then only from the registration requirements of the Act.

an SEC interpretation of the 1933 Act* setting forth the characteristics required of short-term notes in order that they qualify for the exemption from registration provided by §3(a)(3) of that Act. *Sanders I*, 463 F.2d at 1077-79.

The opinion in *Sanders I* acknowledged that, unlike other securities acts where Congress "expressly" included short-term notes within the coverage provided by their statutory protections, the 1934 Act did not; but the court below nonetheless concluded that, "Congress intended to protect against fraud the purchasers of securities such as those involved here under the 1934 act as well." 463 F.2d at 1079-80 (footnote omitted).**

That reasoning is contrary to this Court's most recent interpretation of these securities statutes, where this Court emphasized that, "[T]he congressional purpose does not require resolving every ambiguity in favor of liability . . .", *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 44 U.S.L.W. 4056, 4062 (U.S. Jan. 13, 1976) (interpreting §16(b) of 1934 Act). In that decision, this Court specifically rejected the suggestion that the language and purpose of an express limitation upon the reach of a statutory provision may be disregarded in the name of service to the general remedial purpose of the 1934 Act, even where the provision under consideration is ambiguous:

* Release No. 33-4412, 17 C.F.R. 231.4412 (1961). The language of § 3(a)(3), *i.e.*, "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions", may leave room for interpretative rule-making; the language of § 3(a)(10) of the 1934 Act is precise, clear and unambiguous.

** Petitioners herein were not found to have committed "fraud". The district court held Nuveen liable "on the theory that it breached a duty to make reasonable inquiries . . . ." *Sanders II*, 524 F.2d at 1066.

> "We find this approach unsatisfactory in its focus on situations that §16(b) may not reach rather than on the *language and purpose of the exemptive provision itself.*" *Id.* at 4060 (emphasis added).

Here, where the congressional language is unambiguous, "the texts of the 1933 and 1934 Acts as to the congressional scheme" appear to mandate the conclusion that purchasers of short-term commercial paper cannot base claims upon the 1934 Act, particularly since Congress "had little trouble in doing so expressly" in the 1933 Act when it "wished to provide a remedy" available to purchasers of short-term notes.* *Cf. Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 733-34 (1975).

Maintenance of the distinction between 1933 Act and 1934 Act applicability to commercial paper is of major public consequence. The quantum of commercial paper is huge, and its role in the financing of American enterprise can hardly be exaggerated. For example, at the end of each of the years 1973 and 1974 and at September 30, 1975, there was outstanding more than 40 billion dollars of commercial paper, and over 17 billion dollars of that paper in September, 1975, represented capital raised by commercial paper dealers (61 Fed. Reserve Bull. A-25, Dec. 1975). If dealers in commercial paper are to be held to the liabilities of the 1934 Act, and deprived of 1933 Act statutory defenses (Point II, *infra*), it may be anticipated that major changes

* *See* §12(2) of the '33 Act, which applies to "a security (whether or not exempted by the provisions of section 3 . . .)", 15 U.S.C. §77*l*(2); and §17(c) of the '33 Act, which provides that, "The exemptions provided in section 3 shall not apply to the provisions of this section", 15 U.S.C. §77q(c).

in commercial paper marketing will be required, including substantially increased costs to compensate dealers for their increased risks. We discuss in Point III, *infra,* the uncertainties of these risks under §10(b) as it has been variously construed in the several circuits.

But whatever the touchstone of liability,* this Court should resolve the question as to whether the 1934 Act applies to this type of financing.

II

The decision below undermines the right of persons engaged in the distribution of securities to rely upon the authority of experts, and effectively makes underwriters guarantors of the accuracy of financial statements certified by independent public accounts.

The "principal question" addressed in *Sanders II* was:

> ". . . whether an underwriter of short term commercial paper, who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default." 524 F.2d at 1066.

Assuming *arguendo* that Nuveen was an "underwriter", it becomes pertinent to examine the significance of that appellation in the statutory scheme. The term "under-

* We again note the anomaly that Nuveen, whom the court characterized as acting in a "mistaken but honest belief that . . . [certified financial statements] correctly represented the condition of the issuer", should be held liable under what this Court recently has characterized as "general antifraud" provisions of an Act which expressly excludes short-term notes from its parameters. *See Foremost-McKesson, Inc.* v. *Provident Securities Co., supra,* 44 U.S.L.W. at 4063.

writer" comes from the 1933 Act, 15 U.S.C. §77b(11). As used in the 1933 Act scheme, strict liability is imposed under §11 upon certain classes of persons, including issuers and underwriters, if a registration statement filed in connection with a securities offering is materially false or misleading, subject, however, to specified defenses available to underwriters but not to issuers. 15 U.S.C. §77k.

Section 11(b)(3)(C) provides that, "[N]o person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

• • • • •

"(3) that . . .

"(C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; . . . ."

There can be no doubt that certified public accountants are the prime example of an "expert" upon whose authority underwriters and others (except the issuer) may rely in a registered securities offering. See, for example, §§7, 8(e), and Schedule A, Items (25)-(27) of 1933 Act, 15 U.S.C. §§77g, h(e), and (aa) Schedule A (25)-(27).

The standard by which the conduct of underwriters and others subject to potential liability under §11 of the 1933 Act is to be measured is enunciated in the statute, 15 U.S.C. §77k(c):

> "(c) In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

Here, the opinion below makes plain that Nuveen honestly believed that certified financials by WH's independent public accountants "correctly represented the condition of the issuer," and there is no suggestion in *Sanders II* that Nuveen had any reason to suspect otherwise. Until the decision in *Sanders II*, it had been generally accepted that financials certified by an independent public accountant could be relied upon as "made on the authority of an expert", and that those engaged in distribution of securities were protected against claims predicated upon misleading certified financials which honestly were believed to be accurate. *See, Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968): "[T]he underwriters' counsel did not make a reasonable investigation of the truth of those portions of the prospectus which were not made on the authority of Peat, Marwick as an expert"; and, "Hence, they have not established their due diligence defense, except as to the 1960 audited figures." (Footnote omitted.)

As a practical matter, *Sanders II* eliminates reliance on WH's public accountants as experts. It says that Nuveen should have asked the accountants to "see any [of their] working papers used in the preparation of its semiannual statements," 524 F.2d at 1068, because Nuveen—character-

ized as an "underwriter"—"is under a duty to make at least some investigation directed at the question whether the *ever present* possibility of fraud is in fact a reality," * *Id.* at 1071. But it would here appear that the only potentially productive inquiry Nuveen could have made that would have revealed fraud in which WH's public accountants participated would have been to audit the auditors,** a hindsight standard of prudent conduct effectively requiring that all expert opinions not be relied upon regardless of the ostensible integrity, independence and competence of the expert.

The anomaly in imposing a higher duty upon "underwriters" through the medium of §10(b) of the 1934 Act than that specifically imposed upon underwriters under §11 of the 1933 Act is apparent. It is urged that this Court should speak to the question of whether expert opinions, particularly those of accountants, may be relied upon—in the absence of any ground to believe they are suspect—by participants in the distribution of securities.

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* Emphasis supplied since, if this possibility is "ever present", what Nuveen failed to do here presumably must be done by underwriters in all cases hereafter.

** That, of course, is what uncovered the fraud and caused both WH and its accountants to be criminally convicted. *Sanders II*, 524 F.2d at 1068 & n. 4.

III

This Court should state definitively the standard by which liability under Rule 10b-5 is to be determined.

At least three different and conflicting standards have been advanced by the circuit courts of appeals in respect of the standard of diligence required of defendants in searching for and disclosing material information to purchasers or sellers of securities. These differing tests can produce irreconcilable conclusions on issues of liability in cases under §10(b) of the 1934 Act and Rule 10b-5 thereunder; and the case at bar well illustrates that a defendant's liability may turn upon the fortuity of where he is sued.

Something akin to, albeit less stringent than, the proof of "scienter" required to establish common law fraud seems to be an essential element of a plaintiff's 10b-5 claim in the Second, Fifth and Tenth Circuits; *i.e.*, the defendant's material misstatement or omission must have been knowing or reckless. *See, e.g., Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973); *Vohs* v. *Dickson*, 495 F.2d 607, 622 (5th Cir. 1974); *Clegg* v. *Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).

A negligence standard seemingly has been enunciated by the Eighth Circuit. *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), and the Seventh Circuit apparently applied the negligence measure to defendant's conduct in *Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1104 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042).

Finally, there is the "flexible duty" standard fashioned by the Ninth Circuit in *White* v. *Abrams*, 495 F.2d 724 (9th

Cir. 1974). *Also see, Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974). This measure of 10b-5 liability would rely upon a host of evaluative criteria, essentially geared to a case-by-case analysis of the circumstances. In the case at bar, the court below purported to apply the "flexible duty" standard:

> "... the broad question whether there is a generally applicable standard of culpability in Rule 10b-5 cases lying somewhere between the extremes of common law fraud on the one hand and mere negligence on the other. We assume the standard may be phrased differently in different circumstances." *Sanders II*, 524 F.2d at 1069 (footnotes omitted).

Under such a standard, however, as applied to "underwriters", surely consideration must be given to the congressional policy reflected in §11 of the 1933 Act which exculpates from liability underwriters who rely upon the opinions of independent experts (*see* Point II, *supra*).

Absent such consideration, what emerges from the opinion below is an unarticulated absolute liability standard. By imposing an affirmative obligation on Petitioners to ferret out "the ever present possibility of fraud", the "favorable recommendation of the issued security" found "implicitly" in Nuveen's relationship to respondent (524 F.2d at 1070), to whom no representation was claimed to have been made, comes perilously close to holding Petitioners to a guarantee by Nuveen that WH's notes would be paid when due.

Whatever the standard of conduct by which an underwriter's or dealer's liability is to be determined, it patently

should not depend upon the fortuity of where he may be sued. The members of SIA—who engage in distribution of securities in nationwide offerings—find themselves in the unenviable position of having their 10b-5 liabilities measured differently in different circuits. In the circumstances, a clear statement by this Court as to the standard for determining 10b-5 liability is essential to the orderly transaction of business in the securities markets of the Nation.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari to the Court of Appeals for the Seventh Circuit should be granted.

February 2, 1976

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-1065

JOHN NUVEEN & CO., INC., A CORPORATION, INVESTORS SYNDICATE OF AMERICA, INC., A CORPORATION, AND INVESTORS DIVERSIFIED SERVICES, INC., A CORPORATION,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

OBJECTIONS TO MOTION OF LEHMAN COMMERCIAL PAPER INCORPORATED FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITIONERS.

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Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

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Pursuant to Rule 42(3) of the Rules of this Court the Respondent hereby objects to the motion of Lehman Commercial Paper Incorporated ("LCPI") for leave to file a brief as *amicus curiae* in support of the petition for a Writ of Certiorari. Respondent received a copy of LCPI's motion on February 2, 1976, and these objections are seasonably filed.

LCPI states as grounds for its motion that it is affected by developments in the federal securities laws affecting commercial paper and that the decision below "is the most significant judicial pronouncement in this area in recent years." Motion, 2.

LCPI apparently believes that it is newly and freshly affected by the supposed holding of the court below "in substance that commercial paper notes . . . may constitute 'securities' for purposes of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and that a commercial paper dealer is an 'underwriter of such securities subject to liability under Rule 10b-5 . . ." Motion, 2.

The ruling that commercial paper may constitute a security was made in a 1972 decision in this case by the Court of Appeals. *Sanders* v. *Nuveen*, 463 F. 2d 1075 (7th Cir. 1972), *cert. denied* 409 U. S. 1009.

There is no issue as to whether the seller of commercial paper in this case, John Nuveen & Co., Inc., was an underwriter of the commercial paper purchased by respondent and the class he represents. As the Court below stated, "The conclusion that Nuveen was an underwriter is not challenged." 524 F. 2d 1064, 1067 (7th Cir. 1975).

Movant not only does not make the showing required by Rule 42(3) in order to appear before this Court as *amicus*, but seeks to argue in this case one issue that was decided four years ago in a different decision, and another issue that is precluded by the acknowledged facts in the case.

Respondent suggests that LCPI's motion should be denied.

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